



GUARANTEES FOR SLUM UPGRADING

Lessons on how to use guarantees to address risk and access commercial loans for slum upgrading

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Left: *Locals in Amui Dzor discussing on slum upgrading project, Ghana.*

Photo © Ruth McLeod, March 2008.

Right: *Women in Solo, preparing roofing materials for upgrading their housing Indonesia. Photo © Ruth McLeod, October 2008.*

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1 Introduction

It is estimated that up to 1 billion people live in slums in the cities of the world – one sixth of humanity – and that the numbers are rising. The UN-HABITAT Slum Upgrading Facility Pilot Programme was established in 2004 to examine ways in which innovative finance mechanisms can help address this problem.

The Slum Upgrading Facility is a technical cooperation and seed capital facility with a central purpose: to test and develop new financial instruments and methods for expanding private sector finance and public sector involvement in slum upgrading on a large scale. It is funded by the governments of the United Kingdom, Norway and Sweden.

The Slum Upgrading Facility (SUF) operates under the premise that slums can be upgraded successfully when slum dwellers are involved in the planning and design of upgrading projects and able to work collaboratively with a range of other key stakeholders. Slum Upgrading Facility works with local actors to make slum upgrading projects “bankable” – that is, attractive to retail banks, property developers, housing finance institutions, service providers, micro-finance institutions, and utility companies. Slum Upgrading Facility has pilot projects in Ghana, Indonesia, Sri Lanka and Tanzania, where various approaches are being tested to support the purpose of the Pilot Programme.

Slum Upgrading Facility Local Finance Facilities and “Finance Plus”

A key element of Slum Upgrading Facility work thus far has been in the establishment of Local Finance Facilities, which are institutions set up to help communities access credit from local commercial banks. In the case of Slum Upgrading Facility, the finance facilities take the form of independent not-for-profit companies that are linked to existing local financial bodies, such as a local bank. Five Local Finance Facilities have been established thus far. Four are at the city level in Solo and Yogyakarta in Indonesia and in Sekondi Takoradi Metropolitan and Tema-Ashaiman in Ghana. In Ghana, the two facilities are being managed under a joint Secretariat. The fifth facility has been established as a national facility in Sri Lanka, and the sixth, also a national facility, in Tanzania.

Slum Upgrading Facility Local Finance Facilities² have the remit to provide the following forms of assistance:

- Technical assistance to ensure the development of bankable projects and programmes;
- Where applicable, loan guarantees and bridge financing to facilitate access to commercial bank loans, and;
- Catalytic grants to provide inputs that will make a critical difference to successful project planning and implementation.

In other words, Local Finance Facilities are about more than just finance. They are about “Finance Plus” – bringing key players together, integrating commercial finance into slum upgrading and providing mechanisms to blend different sources of finance, among other things.

What is this paper all about?

In August 2008, a technical workshop on the use of Guarantees to support slum upgrading work was held in Coventry, U.K. The aim of the workshop was to share experience over the last ten years of structuring and negotiating guarantee arrangements, and this paper is a result of that workshop³.

Although global experience on the use of guarantees for slum and settlement upgrading is limited, practitioners are using guarantees successfully in the field. It is clear that guarantees for this specific purpose are complex and new to most bankers. Experience in using guarantees has varied considerably, as have the contexts in which guarantee arrangements have been negotiated.

This paper has been produced to try and provide an overview of lessons learned about guarantees for slum upgrading so that others might benefit from them. This paper is not about promoting guarantees as a product in themselves. It is about exploring how guarantees have been used and can be applied as a useful tool in slum and settlement upgrading – an area where it has traditionally been very difficult to “unlock” commercial finance.

2 For a detailed explanation of Slum Upgrading Facility Local Finance Facilities, please visit www.unhabitat.org for an electronic copy of Slum Upgrading Facility Working Paper 8: “Slum Upgrading Facility Local Finance Facilities: what they are, why they are important and how they will work”.

3 The meeting included practitioners from Homeless International, Guarantco, Society for the Promotion of Area Resource Centres, Dutch International Guarantees for Housing (Dutch International Guarantees for Housing), USAID Development Credit Authority, Swedbank and the UN-HABITAT Slum Upgrading Facility (Slum Upgrading Facility) and Experimental Reimbursable Seeding Operation (ERSO). See page 72 for a complete list

A quick word on guarantees and the Slum Upgrading Facility

What is a Guarantee? It is a legal agreement to provide security for a loan. If the loan is not repaid according to the terms and conditions agreed, the guarantor must give up the security that has been provided to cover all or part of the loss. (McLeod, Mullard, 2006)

The Slum Upgrading Facility, as a Pilot Programme, builds on the experiences of others in exploring and supporting slum upgrading finance. More and more, it is clear that the main constraint to slum upgrading is not simply financial – it is a much more complicated set of barriers that arise from unclear land tenure, weak social and community organisation and a lack of political willingness and technical “readiness” to take projects to a level at which banks can get involved.

There are many factors at play, and the Local Finance Facilities are a means to address and work through that complexity with all key players involved. However, once community driven slum upgrading projects reach a certain level, they do need financing. Sources of appropriate financing need to be identified, not just for isolated projects, but in order to develop systematic financial access that underpin city wide and national scaling up of slum upgrading interventions. Grants cannot cover the scale of financing that is needed, and the only realistic option is to find ways to tap local financial markets. Essentially, this means accessing commercial bank finance on a medium and long term basis.

How do people get started accessing finance? One of the ways is to arrive at a discussion with the bank with a guarantee in your “back pocket”. A guarantee provides a way to reduce the discomfort that a banker may feel in lending to a group or for a purpose with which she or he is not familiar. It can help get the discussion going because if the banker knows a guarantee is available, they also know that they don’t have to take the sole risk in determining the likelihood of a loan being repaid.

Why are loans for slum and settlement upgrading different from other kinds of loans?

Lending for slum upgrading is complex. We discuss and clarify some of the reasons why it is so complex below:

- There are multiple complex elements within each project, requiring a wide range of social, technical and political inputs for successful implementation.

Loans for slum and settlement upgrading usually have to be combined with a range of technical assistance in non-financial areas. Within Slum Upgrading Facility, this is referred to as “Finance Plus”. Critical elements in “Finance Plus” are land access, allocation and regularisation; building design, technology, permissions; community organisation, infrastructure provision, etc.

Experience has shown that projects are rarely fully developed and ready to go, apart from being able to access commercial finance. In practice, considerable technical inputs may be required because projects are at varying levels of readiness.⁴ All the organisations involved in providing guarantees also provide some form of technical assistance to get projects to a “bankable” stage, and beyond.

For example, GuarantCo can access funds from a special Technical Assistance Fund (supporting all the PIDG facilities) for carrying out market studies and preparing business plans up to \$75,000 / project.

For the pilot projects within the UN-HABITAT Slum Upgrading Facility, the boards of the newly-created Local Finance Facilities are composed of representatives from many of the key agencies that will be needed to assess and support the projects. In addition, during the Pilot Phase, access to technical expertise on anything from engineering inputs to financial modelling support is being provided by the Slum Upgrading Facility Pilot Team.

■ **Each project has to deal with a multiplicity of institutional and political actors in relationships that have little if any previous collaborative history.**

A wide range of institutional and political actors are inevitably involved in a slum or settlement upgrading programme. The relationships between the various groups need to work effectively, and often, these groups have never worked together before. Building collaborative partnerships takes significant time and effort.

Fortunately, the governance structure of the Slum Upgrading Facility Local Finance Facilities encourages the participation of all actors (from slum dwellers themselves to local and central government and commercial and professional stakeholders). This helps to create credibility and a track record of hopefully, successful collaborative approaches, making future projects smoother.

⁴ This has been the experience of many programmes that deal with slum upgrading and finance, including GuarantCo, Dutch International Guarantees for Housing, Slum Upgrading Facility or Homeless International.

- **The financing required is usually medium to long-term in nature.**

Slum and settlement upgrading requires medium and long-term finance. This is often a gap in local financial markets, as the kind of long-term investment and deposits needed to underpin medium and longer term lending are not in place. The focus in many financial institutions is on shorter term lending.

Micro finance institutions are increasingly recognising that loans for housing are needed by many of their clients. The problem is that the capital base of most micro finance institutions does not easily support loans with terms in excess of a year, let alone ten or fifteen years.

- **There is no guarantee of complete cost recovery from the end borrower because the solution required costs more than slum dwellers can afford to repay.**

New construction and renovation in urban areas is expensive. This is particularly so in larger cities, where the land occupied by slum dwellers is frequently in demand for commercial development and where plot prices may be inflated by inappropriate and unaffordable plot size requirements stipulated in local planning regulations. Construction costs, particularly when cement and steel based technologies are being used, are also expensive.

What this means is that development and upgrading that meets the standards set by building and planning authorities are usually completely outside the income range of low-income slum dwellers. Projects are simply unaffordable and there is no chance of full cost recovery from low-income slum households.

The most obvious way around this is to use direct state subsidies. However, this is dependent on the state being able and willing to provide subsidies of the right kind and in a way that makes sure they benefit the people that they are supposed to benefit in the long term. Part of the Slum Upgrading Facility Finance Plus approach is to work directly with key actors in government to encourage subsidies, especially in the form of infrastructure provision.

Another option, usually as an additional input, is to design a component of internal cross-subsidy into upgrading projects. Parts of a development are carried out purely for commercial purposes. Buildings are constructed and then either rented or sold to create income for a project. This in turn makes the financial design of a project rather more complicated than a standard loan, but this kind of approach needs to be pursued if slum and settlement upgrading are to be effectively used as interventions to address poverty.

- **Projects usually require access to several different kinds of financial service/product, many of which are not currently available within local financial markets.**

Slum and settlement development projects are frequently implemented in phases, which require different forms of financing. In situ development tends to be much more time consuming and complex than green site development.

Low-income households in slum settlements need to have a basic savings and loan system in place if they are to be able to handle longer-term repayment commitments of the kind required for individual housing and upgrading loans. In many cases, help may be needed to boost household incomes through the provision of livelihood loans.

Upgrading projects require project financing to cover site development and construction costs. There may also be a need to finance transit housing when people need to be temporarily relocated in order to implement a project.

Where projects are being developed that provide the potential for scaling up, systemic distortions in local finance systems need to be addressed, the most obvious being the problem of expectations of bribery and pay offs. Refusal to pay bribes causes delays and upsets the system. It is a crucial matter to address but it takes financial as well as psychological and political stamina.

Grant funding may be needed to finance smaller demonstration projects and bridge financing is often required to get projects started and to cover funding requirements when there are delays.

These financial services cannot usually be obtained from the same source. However, it is important that they are used together in a coordinated way. Where guarantees are used in any of the arrangements, it is important to ensure that other linked arrangements are consistent and do not undermine the guarantee arrangement.

- **Borrowers usually lack significant balance sheets and have no established track record in technical project delivery.**

What they may have, however, is a history of savings and repayment for micro-loans in their organised community groups. The challenge here is to translate what they do have into a more formal proof of credit worthiness.

Box 1 Micro finance, micro credit, project finance and community finance: what's the difference?

Microfinance refers to the provision of financial services to poor or low-income clients, including those not formally employed. More broadly, it refers to a movement that envisions “a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers.” Microfinance institutions may provide options for saving in addition to the provision of loans.

Microcredit is a part of microfinance, and is the extension of very small loans (microloans) to the unemployed, to poor entrepreneurs and to others living in poverty who do not meet the traditional requirements of “bankability” – that is, they are without collateral, formal employment and/or a verifiable credit history, for example.

Microfinance and microcredit have an approach that is different from general financing and credit in that they also have development goals. Microfinance has elements of capacity and relationship building so that borrowers are provided with non-financial support in difficult times. Microfinance is generally seen as a tool to support socio-economic development. People sometimes talk about microfinance having a “double bottom line” – where banks make a profit, while slum dwellers improve their lives.

Project Finance is defined by the International Project Finance Association as the financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cashflow generated by the project. In other words, project financing is a loan structure that relies primarily on the project's cash flow for repayment, with the project's assets, rights, and interests held as secondary security or collateral. Project Finance in the case of slum upgrading means that the project is designed in a manner that generates revenue flow – for example, from the rent or sale of commercial property – in order to make the solutions develop affordable to low income households.

Community Finance is the finance that is created when individuals group together to create a capital base that they cannot generate as individuals. The Urban Poor Funds created within the Shack Dwellers International networks are good examples of this. The funds may receive capital from international donors and have been used effectively to support demonstration and pilot projects to test how particular approaches might be applied. However, community finance of this kind is rarely Slum Upgrading Facility-efficient to fund larger slum and settlement upgrading projects with all the elements that are required – housing, infrastructure and land, for example.

Community savings groups

Communities undertaking slum upgrading projects need to be organized. This is an important pre-condition for demand-led upgrading efforts. They come together in community savings groups, allowing them to save and borrow money that is not available to them from formal credit institutions and banks. Communities begin with savings schemes and move to introduce elements of revolving credit. As they grow, they keep records and encourage prompt repayment. They manage risk within the group. More advanced groups save money for specific needs in reserve accounts - and these accounts may now be in more formal micro-credit associations or smaller banks.

Within the Slum Upgrading Facility model, these community micro finance institutions themselves will, in many cases, apply for wholesale or group loans from banks. Their application will be based on the strength and bankability of their overall project, and with the support of guarantees, where needed. They will then provide individual loans for upgrading or building, maintain accounts, and follow up for repayment directly with their community members. This means the social fabric of that community remains intact - as does the personal touch. Community micro finance institutions will charge a percentage onto the interest rate of the loan to fund their involvement.

2 Risks

Guarantees provide a means of managing and mitigating risk. It's useful, therefore, to understand the risks that can arise when guarantees to secure loans for slum and settlement upgrading are being considered.

What is risk? “...Risk is socially defined and constructed; people from different contexts define risk differently, and people's access to and control of knowledge, affects whether or not their definition of risk is accepted by others”. (McLeod, Mullard 2006. pg 40).

Risk is not something concrete that can be measured objectively. It is based on perception. Risk perception will almost certainly vary *within* a financial institution or bank as well as *between* that institution and other interest groups such as slum dwellers, local authority politicians and developers.

Because information asymmetry (where not all parties have the same information) is linked to risk perception, we feel greater risk when we get involved in something we know little about. And the greater the feeling of risk, real or perceived, the more that will be required in terms of guarantees and “comfort factors” *in addition to a project already being bankable*.

Risks can change at different stages of a project or programme. There are risks at the micro level and risks at the macro level. Those involved in the project need to look at those risks and assess whether or not the project is worth investing in and, if so, how those risks are to be mitigated and managed.

What are the main risks when lending for slum and settlement upgrading?

There are a wide range of risks that a bank or financial institution will need to consider when assessing whether to provide a loan and how much to charge for that loan. Each of the risk areas contains many further questions that will need to be asked of the initiative and it makes sense for the individuals or group promoting the project to address these questions in detail before discussions and negotiation regarding a potential loan begins.

The main risk areas listed below are explored in more detail in the text that follows.

1. Credit Risk

Will the loan be repaid? Is the projected revenue stream for the project reliable? Are procedures in place in the case of one or more of the participants dying or moving elsewhere?

2. Asset Risk

Have Slum Upgrading Facility efficient steps been taken to ensure tenure security? If land and the housing built there is to be held as security, will foreclosure actually be possible if loan repayment default occurs?

3. Political Risk

Is there any chance of political interference in the project? For example, might a local politician want to allocate nominated participants to the project? Are local policies supportive of the arrangement? Are elections on the horizon? Will a change in political control have any impact on the way that the project is implemented?

4. Construction Risk

Has the construction process been properly tendered and contracted? Is the contractor able to provide a contractor's bond to cover non-completion of the project? Are procedures in place to monitor the quality of construction and compliance to agreed standards and time deadlines?

5. Economic Risk

Can the participants afford the repayments even if the economic context deteriorates? How likely is it that costs will escalate and the project will require more financing than had initially been projected, resulting in higher repayment requirements?

6. Bribery & Corruption Risk

Construction projects are especially vulnerable to the risk of bribery and corruption because of the many decisions that are required for planning and building permissions. Is this likely to be the case in this situation?

7. Interest Rate Risk

Many loans for slum upgrading and home improvement are negotiated on the basis of a fixed rate of interest throughout the loan period. This helps to reduce potential increases in the cost of finance resulting from variable rates. Another aspect of interest rate risk results from decisions regarding whether interest is applied on a simple or compound basis. The real cost of finance will be lower if interest charges are calculated on the basis of a reducing loan balance rather than charged at a rate applied to the total loan for the entire period of the loan. People can be misled when this level of detail is omitted from the discussions.

8. Market Risk

Market risk is important where a project incorporates commercial components in order to generate revenue to use as an internal cross subsidy. If a proportion of a development is to be sold off or rented out in order to provide project income or revenue, then the project will be vulnerable to changes in real estate prices. When the financial viability of a project is being assessed, it is important to assess how sensitive the overall financing of the project will be to price fluctuations of this kind.

9. Natural Hazards Risk

Many slum settlements are located in areas that are vulnerable to natural hazards. Mitigating these risks may add additional costs to the project. There may also be a need to incorporate insurance coverage into the costs that households will need to cover. In some cases insurance may not be easy to arrange and communities will need to put in place their own measures.

10. Organisational Risk

When a bank assesses a loan, the most important assessment that they make is of the borrower. This is particularly the case when they are dealing with wholesale, group or project borrowing. Banks will look at organisational track record, systems, procedures, leadership, governance, etc., of the community group or other intermediary agency. In the case of larger projects, banks may require an independent credit rating – resulting in an assessment of credit-worthiness by an independent body. They will want

to know that the organisation is not overly dependent on a single individual and that there is a genuine commitment to carrying the project through.

Who assesses risk and how?

At the time of writing, in the middle of a global financial credit crisis, the question of risk has emerged as one of critical importance. It is clear that where risk assessment is carried out inappropriately, moral hazard can produce disastrous results with massive failure in loan repayments and a breakdown in financial systems generally. If the people who assess and rate the risks are the same people who will benefit from the risks being taken, or if information concerning risk levels is not accurately identified or revealed, the rate of non-performing loans is likely to increase significantly.

The risks taken on by banks and other financial institutions are normally subject to regulation by central banks, which are in turn guided by international guidelines. Central banks lay down requirements for different levels and forms of security for different kinds of loans, as well as requiring that banks meet broader capital requirements to ensure that deposits from savers are safe.

Slum dwellers are unusual clients for most banks, and slum upgrading initiatives tend to result in complex projects that banks have little experience in assessing. It is therefore not surprising that when loans are negotiated, banks initially tend to revert to the most conservative interpretation of central bank requirements in order to minimise the risks that they will be taking on. This can result in a straight rejection of a loan application, or it may lead to the bank charging a higher interest rate premium or requiring significant levels of security.

One of the most common central bank requirements is asset security to back a loan for housing. The house that the loan is being used to build or improve, and usually the land on which it stands, is held as security against default in loan repayment. If the loan is not repaid, the house and land can be taken by the bank. The loan is foreclosed and the bank resells the asset in order to cover the loan that it has provided. This is the fundamental basis of mortgage lending.

In practice, however, banks are usually unwilling to apply mortgage lending to loans for slum and settlement upgrading, particularly where these loans are wholesale loans. Foreclosure may in fact be almost impossible, either because it would be judged politically unacceptable or because the legal costs and the time involved would be prohibitive. Rather than assessing and addressing risk from the perspective of mortgage lending, banks will instead want to look closely at affordability, the capacity of households to repay loans, the reliability of income and revenue flows into a project and the quality and reliability of any intermediary borrower. If they are concerned about any of these factors, they will require additional security, normally in the form of a guarantee to cover the risks that they assume that they will be taking on.

How do banks assess the risks involved in providing a loan?

Participants at the 2008 Guarantees workshop pointed out that banks are traditionally very cautious when lending for slum and settlement upgrading and to community groups rather than individuals. They will consider all aspects of risk, and compare those with information and assurance about the project itself. A financial guarantee can be a great incentive to lend. Not only is there a financial backing, but the organisation providing the guarantee also provides legitimacy and technical support to ensure the project is completed.

It is important to a bank to understand who the borrowers (clients) are, what the project is about, who is involved, how repayment will occur and who will manage the project to completion. There are many other questions a bank will ask, and all of these define a “bankable” slum upgrading project.

With slum and settlement upgrading projects, there is the additional consideration that banks often know very little about housing and even less about slum and settlement upgrading. Therefore most projects will be evaluated from the ground up, each time. If efforts have already begun, and a financial commitment already exists to cover at least a proportion of the cost, that shows serious intention by all parties to reach completion. This helps banks make a decision to join in.

In the case of project lending, banks will be keen to arrange to have the first call on project revenues. For example, if a project is to be reimbursed by local or central government for infrastructure provision, the bank will want that money to be channelled in such a way that they can access the funds before they are used for any other purpose. This usually means that agreement will be reached for funds to be channelled through an escrow account, which is an account that holds the funds until the transaction is successfully completed.

From the community perspective, risk may look very different. Banks and their systems can be completely unknown quantities. The ways in which they work can be obtuse and difficult to understand. Their terminology may confuse rather than encourage communication, and the legalese of formal loan agreements may be completely incomprehensible.

People may feel that they are being tricked with hidden fees and unreasonable terms and conditions hidden in the small print of contracts. Most importantly, people may be anxious that they are entering into a loan agreement which, in the case of repayment becoming difficult or impossible, may result in them losing the few assets they already possess.

It is clear that banks and communities may assess risk very differently. However, if they are to reach agreement resulting in a loan, it is important that ways be found for both parties to understand each other and come to a common understanding of how the loan arrangement can best be managed. This process can benefit from the intervention of third party or intermediary organisations that help to facilitate the negotiations as they take place.

Intermediary organisations can provide help in a number of different ways:

- By providing an objective third party verification of the position and analysis of each of the parties;
- By providing instruments to make information that is being assessed more available and transparent – for example developing clear models that clearly identify assumptions being made by the different parties and the impact of these assumptions on projected project cash flow and ultimately project viability;
- By bringing in external resources to assist in detailed project design and management;
- By identifying examples of similar approaches and making the knowledge that has emerged from these experiences available to both banks and communities, and;
- By identifying options for how the concerns of communities and banks can be addressed. For example savings records can be used to substitute for a formal loan track record. Collective construction management systems supported by a range of professionals can be used to substitute for the presence of a highly paid single project manager. Special housing savings can be used to provide individual household deposits to buffer delays in collective repayments.

“Pearls of wisdom” for managing risk

At the Coventry Guarantees workshop in August 2008, there were a range of suggestions regarding risk assessment, management and mitigation from the complex and unique perspective of slum upgrading. Some of these “pearls of wisdom” are outlined below.

Assessing affordability

When affordability is being assessed, it is important to look at disposable income rather than income per se. When households see an opportunity to make a serious investment in housing they may go to great lengths to repay associated loans, bringing in payments from the extended family, for example. Conventional repayment to income ratios need therefore to be applied sensitively and in the context of the household’s other outgoings.

Make use of subsidies where possible

One of the best ways to make a project affordable is to make sure that all possible subsidies are accessed. Subsidies may be available in the form of land, infrastructure, technical assistance, small scale grants and so on. In the slum upgrading projects that Society for the Promotion of Area Resource Centres has supported in Mumbai, projects required no repayment by individuals benefiting from the new homes because of a specific policy framework promoted by the Maharashtra government which provided access to a range of subsidies including Transferable Development Rights.

The Society for the Promotion of Area Resource Centres (Society for the Promotion of Area Resource Centres) is an Indian non-governmental organisation working to organise and support slum and pavement dwellers to address issues of urban poverty and to collectively produce solutions for affordable housing and sanitation. Society for the Promotion of Area Resource Centres has very successfully made use of a concept called Transfer of Development Rights (Transfer Development Rights) for slum and settlement upgrading in India.

Transfer of Development Rights, or Transfer Development Rights, is a land management tool that enables governments to generate financial resources by allowing landowners or developers to build more than they are allowed by the land use plan (for example, more levels making the building taller). With that money, governments can then finance upgrading or other housing for the urban poor. The Transfer Development Rights strategy works best in situations where land is extraordinarily valuable, like Mumbai, which now has some of the world's highest land prices.

In several of the on-site slum redevelopment projects being developed in Mumbai by the Society for the Promotion of Area Resource Centres/Mahila Milan/National Slum Dwellers Federation alliance, they are using sold-off Transfer Development Rights not only to pay for the construction on multi-story apartment blocks for rehousing slum-dwellers on the same sites for free, but also to build a capital fund to finance other housing projects and to use to negotiate with the state for more land and resources for housing.

Source: Sunder Burra, quoted from UN-HABITAT publication "Housing the Poor in Asian Cities"

Make sure slum dwellers are involved from the beginning

Slum dwellers themselves face risks in taking on loans. Are those loans affordable? Will construction / upgrading be completed? Will they be able to manage long term loans? By slum dwellers themselves being involved in the project from the outset, these risks should be considered and addressed.

Build Partnerships

Reaching consensus on the risks that need to be managed and mitigated is challenging, but consensus can only be reached when various different partners and stakeholders agree. This is best done through on-going partnership (Local Finance Facilities have been established to do just that). The more different actors know and trust each other, the more information and power each will have to take action.

Experience has been that guarantee gearing ratios can be reduced when an organisation has a long history of successful projects with satisfactory repayment rates. Society for the Promotion of Area Resource Centres has a track record to prove that they are credit worthy. Over time, the guarantees required by banks for their projects has decreased from 150% at the beginning to a guarantee gearing of 10% or less now - and some projects required only a collateral lien placed on Transfer Development Rights and sale units. The challenge for new organisations working with guarantees in slum upgrading is to move from arrangements built on personal relationships to standard agreements for guarantees. That means that the historical record helps in assessing risk. When an organisation or organised community is starting from scratch, it is more likely that they will be seen to be riskier.

Credit ratings and slum upgrading

It is possible to advocate for a type of Credit Rating, although this takes a retrospective view of loan repayment performance. In practice, it's a way of symbolically representing agencies repayment track record. However, when the relationship is new, other mechanisms are needed to establish the necessary level of "comfort" with the arrangement.

As a representative from Dutch International Guarantees for Housing put it, "You can't solve risk assessment by rating an organisation that has no past. Assess the project or organisation yourself. Don't trust anyone else. You need to know a lot about housing projects and a lot about banks. It's very rare for a bank to understand much about housing".

In this new area of work banks are looking for strong organisations (debt coverage) rather than strong projects, and for large profit margins rather than sustainability and replication. Bear in mind that there is no way for a bank to count social impact and then gain credit for it.

Making banks comfortable

Banks need to know that things have already begun, that a financial commitment already exists to cover at least a proportion of the cost and that there is a serious intention by all the main parties to complete the project. As Dutch International Guarantees for Housing put it "we give the message that we can bring our own money with us and start". Society for the Promotion of Area Resource Centres operates in the same way. They make it clear that the project will proceed with or without the involvement of that particular bank when they are negotiating.

The workshop participant from Citibank felt that the project plan was critical when the product is essentially project financing. How will the bank be repaid? What is the business rationale behind the project? Who is the real client? How is repayment going to happen? The guarantee functions as a support mechanism to cover specific risks, but it is not just financial. An important part of providing a guarantee is the provision of technical support for a project which enables other investors to come into a project.

Looking at governance, inappropriate regulation and cost controls are important. Another key risk for Citibank would be franchise or reputation risk – entering into an arrangement that might lead to damage to the lender's brand image. Other participants felt another major risk is that the project will not be finished. Making sure that the contractor can complete the job or, if they fail, that someone else can, is also crucial.

Reducing risk where you can

It is possible to reduce risk by diversifying sources of repayment and carrying out sensitivity tests. The main thing is working out what the real cost of money is. Different interest arrangements need to be made transparent so that their cost implications are clear.

When loan repayment collection processes are designed to fit in with the savings rhythms of borrowers, the chances of default are lowered. For example, in a Slum Upgrading Facility project in Ghana, banks offering a loan for a market redevelopment are providing personnel to facilitate daily loan repayment collection.

Make sure that the whole cost of a project is analysed so that each cost also be identified, and plans can be made for covering those costs. There are examples of important costs being omitted from projects – soil testing, land infill, unskilled and skilled labour, “refreshments” required when community labour is used, and more.

Combining strategies to address livelihoods and lending for housing and settlement upgrading is an important means to ensure loan affordability and to minimise the risk of default. It's no good expecting someone to move into new housing, away from their livelihood base with no alternative income generating base provided and expect that loans will be repaid.

Many households are using remittances from family members working abroad to repay loans. However, the amounts of these remittances vary and arrive irregularly. There is a lot of on-going research into the potential for harnessing and leveraging remittances, but the most important thing to a bank is the beneficiary of the remittance and their competence and track record rather than the remittance itself.

3 Guarantees

What are guarantees?

A guarantee is a legal agreement to provide security for a loan. If the loan is not repaid according to the terms and conditions agreed, the guarantor must give up the security that has been provided. (McLeod, Mullard, 2006)

Guarantee Agreements are irrevocable agreements that cover arrangements in the case of failure by a borrower to repay a specified loan as set out in an associated loan agreement. The Guarantee may cover the outstanding loan together with interest, the banks reasonable costs, charges and other expenses and up to but not exceeding the guaranteed amount specified in the agreement.

Although this paper is mostly concerned with guarantees in the financial sense, there are many elements of partnerships between banks and organised slum dwellers that could be defined as non-financial guarantees. Of course, in the sense that they are not irrevocable agreements, they can instead be considered “comforts”. This intangible “comfort factor” arises in negotiations with banks, and was described by Homeless International as an “intuitive sense that lending in a particular context feels right”.

Intangible or not, the so-called comfort factor is a real concern. All partners need to feel that they have enough information and answers to proceed, and the confidence that, should obstacles arise, there is commitment and authority to deal with those problems. This is the comfort that long-established organisations like Society for the Promotion of Area Resource Centres can provide, that the backing of Homeless International offers, and that the support of Dutch International Guarantees for Housing brings. This is also what the Slum Upgrading Facility Local Finance Facilities are designed to address. Local Finance Facilities provide a forum for everyone involved to work together throughout, so that problems can be solved at each stage of the project.

Providing “comfort” to a bank would include satisfactorily responding to questions such as:

- Who is the project manager and what are his or her qualifications?
- Are there systems of support in place in the event of non-repayment of the loan?

- How much support is being provided by the municipality?
- What kind of savings history does this group have?
- What is the profile of the community group? What is their history together?

Guarantees offer more than finance, and this is important. A CSFI/CGAP/Citibank report entitled “Microfinance Banana Skins 2008” finds that the greatest risks lie in “poor management and inadequate corporate governance”. More information can be found at <http://www.cgap.org/p/site/c/template.rc/1.9.2956>

Why and when are guarantees needed?

Guarantees provide security for a loan. They are needed after negotiations with banks have been held and the main risks associated with the project have been analysed and costed. Where the cost is not covered by the interest rate negotiated for the loan, the bank will require additional security. This is where guarantees are normally introduced, as necessary, to satisfy a credit committee or to meet central bank requirements.

Experience shows that in each instance, and with each different project, the need for a guarantee will vary – as will the way in which it is structured. Factors influencing the contents of the guarantee agreement will include central bank requirements, whether or not this is the first time that the bank and the borrower have entered into this lending for this purpose, how high an interest rate has already been agreed and, in the case of a foreign exchange guarantee, what the assumptions are regarding potential exchange rate movements.

That said, one of the most important things about a guarantee is that it can be used to open doors. Banks will usually be willing to enter in discussions regarding a new type of lending if it is clear that ways can be found to cover potential risks associated with that lending. A cash guarantee provides an excellent way to do this. However, it is also important that it is made clear that the guarantee arrangements should be negotiable and, as far as possible, that risk taking should be shared between the different parties. In other words, banks need to take some risk themselves.

The main thing about a guarantee is that it is an irrevocable agreement that confirms that a secured loan will be repaid. When an individual or agency agrees to act as a guarantor it is important for them to apply the same criteria as if they were giving the loan themselves. This is especially true where the guarantee is taking the full risk.

The experience of Society for the Promotion of Area Resource Centres around guarantees is interesting. In the words of Aseena Viccajee of Society for the Promotion of Area Resource Centres: “Lenders look for security when they part with funds to limit the Bank’s risk as a lender. Lenders like to have another organisation independently examining the proposal. There is an absence of normally-used parameters – balance sheet indicators for example. Many of the projects cannot offer any collateral. Sanitation projects are an example of this – there is no transfer of title. Banks tend to look for a strong organization rather than a strong project and large profit margins rather than sustainability. They have no way to either measure or give credit for the positive social impact. Not-for profits have no capital and not-so-strong cash flows and are dependant on market and state based subsidies. The absence of assets and cash collateral of the not-for-profit equals discomfort!

Is there a need for guarantees? In the absence of traditional security, banks find it easy to fall back on a guarantee mechanism. By asking for a guarantee, the lender is giving the bank a “vague” feeling of comfort. There is no clear reason why a bank studying and evaluating a proposal should ask another bank or financial institution to take up the risk if they feel the project is sound. The result is that a non-governmental organisation faces the task of undergoing evaluation at multiple levels. One more institution, perhaps of higher credibility and standing, evaluates the proposal. Maybe the guarantor is more familiar with the history, credibility and background of the not for profit or community organisation.

With a guarantee, boards and auditors can be more easily satisfied. Of course, you cannot mortgage units - that would mean pushing poor people on the street. Only lien on Transfer Development Rights or sale units which are built after rehabilitation and inflows come at the end of the projects. The availability of a guarantee amount as first recourse will increase the period for which the asset need not be classified as Non Performing Asset.”

Do they work the same everywhere?

Guarantees do not work the same everywhere. Each project will be different, and there will be variation in requirements from banks (such as central bank requirements governing lending and borrowing) as well as national and regulatory contexts.

The experience of USAID Development Credit Authority, Homeless International and Dutch International Guarantees for Housing suggests that each guarantee arrangement needs to be customised to reflect the specific features and characteristics of the projects and programmes for which loans are required. However, as more arrangements are made, it does become possible to systematise guarantee agreements so that their wording is similar. It also helps to identify key headings that represent non-negotiable elements and others that are clearly negotiable.

Context Matters. The US Financial Crisis happening now (2008/2009) means that credit is less available, and banks may be less willing to explore new, seen-to-be-risky markets. However, the World Bank sees what is needed as more thoughtful application of a variety of tools, from policy to guarantees, in order to avoid the problems of the subprime crisis: “As policy makers in emerging market seek to move lenders down market, they should adopt policies that include a variety of financing methods and should allow for rental or purchase as a function of the financial capacity of the household. ...It is possible to extend mortgage lending down market without repeating the mistakes of the subprime boom and bust.” (World Bank, 2008. The Sub Prime Crisis: Implications for Emerging Markets, 2008. PRWP 4726)

It may mean that guarantees will be needed more than ever, and that ratios will initially be more favourable to banks. Or it may be that those factors that contribute to loan default in a sub-prime market will become clearer – and therefore more risks can be addressed in advanced. It is hoped that over time, as the Slum Upgrading Facility projects demonstrate successful repayment, the amounts required for guarantee purposes will be reduced so that greater finance for slum and settlement upgrading can be leveraged.

It is worth noting that there are key contextual elements that determine just how useful guarantee provision can be. Where a banking sector is developed, financial markets function reasonably efficiently and the capacity to implement complex upgrading projects is available, guarantees can prove extremely useful instruments. However, if the local banking sector is not developed and has minimum outreach, it is unlikely that guarantee arrangements will be a viable option.

How are guarantees structured?

Guarantees can be provided in many different forms.

Asset based

The loan is secured with an asset of some kind. This can be a house in the case of mortgage lending, or may be a less valuable asset, such as a motor bike or television. In the case of an organisation, land or real estate may be used as security. In each case, however, the bank retains the right to take over the asset in the case of default on loan repayments.

Cash based

A cash deposit is held under lien (i.e. it cannot be used for any other purpose). The deposit can earn interest but will be “called on” to cover any loan repayment defaults. This kind of guarantee can work well, but the rate of interest applied to the deposit is important. In some cases, a reduction in the interest rate applied to deposits is negotiated in exchange for a reduction in the interest rate applied to the loan itself.

Hard currency

Cash-based guarantees can be provided in hard currency. This is sometimes used as a means of protecting the value of the guarantee funds against potential exchange rate fluctuations. This is

important if depositors have invested funds to back the guarantee and eventually want those funds reimbursed in the same currency. Homeless International's Guarantee Fund runs on this basis. Hard currency guarantees can also be useful when local currencies are likely to devalue against established hard currencies - when loans are repaid, larger loans can then be secured, because the value of the guarantee funds themselves will have increased relative to local currencies.

Balance sheet

An organisation may issue a letter of guarantee simply based on the value of its balance sheet with the guarantee being noted in the accounts as a contingent liability. The guarantee as such does not appear in the balance sheet, since it is an off-balance liability. Of course, once it is evident that the guarantee might cause losses, provision for those losses will have to be made and this will be shown both in the balance sheet and the profit and loss statement. Similarly, once a demand notice has been made and a payment drawn from the guarantee, the cash payment will be shown in the balance sheet.

Letter of Comfort

In some cases, a bank may not require a cash or asset based guarantee, but may require the additional comfort of knowing that a third party is committed to helping resolve the situation if problems arise with repayment.

For example, when Axis Bank in India provided a guarantee to Society for the Promotion of Area Resource Centres so that community contracts for toilet blocks could be taken on, the Bank asked Homeless International to provide a letter of comfort which said that it would commit to providing technical and organisational support to Society for the Promotion of Area Resource Centres should difficulties arise. In this case, there was no legally binding financial commitment, but rather a moral assurance that help would be available. This kind of comfort guarantee becomes possible when an organisation is well established and has a proven track record.

Portable "back pocket" guarantees

This is an arrangement where a guarantor assesses an organisation and commits to providing a guarantee that the organisation can use to negotiate with a range of potential lenders. It has the advantage of helping organisations to explore a range of lending options from a strong negotiating position. In the context of the Slum Upgrading Facility, Local Finance Facilities will have this type of portable guarantee, and will use it to shop for the best finance for a particular project.

Contractor performance guarantees

This type of guarantee requires that a contractor takes out indemnity to cover the risk of their own non-performance. It is an important form of guarantee where construction projects are complex and subject to delays and quality control issues.

First-loss (also known as “top slicing”) guarantee

A first-loss guarantee covers the first default on a loan up to a specific percentage of the total loan amount. For example, on a 50% first loss guarantee in the case of default, the first 50% of the loan that is not repaid is covered by the guarantee, which can be called down. Any losses beyond 50% of the loan amount will have to be covered by the bank. This is the safest kind of arrangement from a bank's perspective, because their maximum risk is covered.

Pari passu (literally “side by side”) guarantee

Any loss as a result of default is shared in an agreed proportion. For example, the USAID Development Credit Authority scheme usually provides a 50% pari passu guarantee. In the case of default, the Guarantor covers half the loss and the bank covers the other half. The advantage of this arrangement is that the bank has a strong incentive to manage defaults carefully right from the start and not to simply step in after the first loss has been covered by the guarantor.

As Alison Eskesen of USAID put it: “Pari Passu guarantees mean guarantor organisations can leave a lot of the detail to the banks, because the risk is shared horizontally – that is, all defaults are split 50/50. That means the banks themselves must take some risk right away, and are more likely to be more involved in risk and assumption management from the beginning”. By the same token, the guarantor can rely on the involvement and procedures of the bank to manage and monitor the loan, and may therefore need to be less involved in the project itself.

Issuing guarantees is more complicated than issuing loans, as there are always at least three parties – the lender, the borrower and the guarantor. And while 99.99% of all loans issued by Swedbank, for example, are issued by local bank officers, 100% of all guarantees are issued by bank lawyers. This adds additional layers of complication. (Stig Jonsson, Swedbank).

How do guarantees work?

Guarantees essentially work two ways: one, to secure the loan in the first place and two, to cover losses in the event of a non-performing loan.

Guarantees are irrevocable agreements that provide security to a lender to fully or partially cover the perceived risks of a lending arrangement. They are helpful in slum upgrading work because they can be used to provide additional comfort to a lender who is not comfortable about lending to an organisation or for a purpose that the bank has not previously experienced.

In the event of default on a loan, or when the loan is not repaid according to schedule, the guarantee would be “drawn down”. Different organisations have different experiences in this, but in all cases, there is some level of follow-up that must be done, such as notice periods, action from the bank, time available for a partner to intervene with communities, developers and the local micro-finance

institution, etc. Elements that cover and define how and under what conditions a guarantee can be drawn down should be built into any guarantee agreement.

For the borrower and for the group providing the guarantee, it is preferable that this be conditional (i.e. that banks and partners need to fulfil various conditions where a non-performing loan could improve) rather than demand-based (i.e. where a bank simply makes the demand for payment of the guarantee or a percentage of it). Banks prefer guarantees that are unconditional. Again, a balance needs to be worked out between these competing demands.

What happens in case of default?

When a guaranteed loan goes into default, the clauses covering default in a guarantee agreement are activated. In the simplest case of an un-limited on-demand guarantee with direct liability, the procedure would be as follows: the lender will make a demand notice and the guarantor will have to pay the principle, accrued interest and costs as per the conditions of the guarantee. The lender is cleared and the guarantor takes the place of the lender, hence it will be a matter for the guarantor and the borrower on how to go forward to solve the default situation, take legal or other actions, etc. The lender in this case is the passive party.

In the case of an unlimited pari-passu guarantee to cover only realizes losses, the lender has to take full responsibility for the recovery process, including taking legal action, foreclosures, selling assets, etc. Only after that can the lender claim from the guarantor actual and proven losses. In this case, the guarantor is the passive party.

In one guarantee arrangement backed by Homeless International, the intermediary organisation managing repayment to the bank failed to keep up repayments in the seventh year of a ten year loan. The bank notified Homeless International of the situation and gave six months notice of its intention to call on the guarantee. The intermediary organisation was facing significant problems and was unable to catch up with repayments and the guarantee was eventually called, with funds equating to the outstanding balance of the loan being withdrawn from funds held under lien in line with the guarantee agreement. Over subsequent years a proportion of the outstanding loan balance was paid back to Homeless International by the intermediary organisation but eventually the balance had to be written off. Fortunately, the Homeless International Guarantee Fund had retained interest earned by the Guarantee deposits and was therefore able to cover the loss without having to draw on the guarantee deposits provided by the Homeless International's own supporters.

There may be a mismatch between assets and liabilities and this can be addressed by a “put” option. A loan for a toll road example is shown below.



In practice, GuarantCo would try and persuade the borrower to stay within the original arrangement, but would help by providing an extra level of coverage. In most cases, projects such as this are refinanced after approximately five years.

Quite often a guarantee may be released as a result of refinancing of the project.

Who can guarantees help?

Simply put, a guarantee solves the problem of uncertainty or lack of information between bankers and those asking for the loan, and it helps share the risk. It addresses what is called information asymmetry – when one group knows more about the situation than the other. Since in this case the bank is doing the lending and therefore (from their point of view) taking on the risk, guarantees predominately help bankers make the decision to enter the low-income market, even if this goes against traditional banking practice.

The offer of a guarantee from another organisation means that organisation is also taking on risk – and therefore independently assessing the project. By helping to remove uncertainty, guarantees can mean a project can go ahead. In this respect, they help everyone involved - bankers, developers, contractors, communities, local government, and non-governmental organisations.

During the Guarantees workshop, Dutch International Guarantees for Housing presented the idea of a value chain for low income housing – which generally starts with an idea, then considers, land, policy and laws, moves on to an organisation capable of doing investments, then financing in place and construction done, and finally, selling projects / rental administration. In Dutch International Guarantees for Housing experience, housing finance tends to deal with end users and not with financing suppliers along the value chain. Dutch International Guarantees for Housing is able to focus on suppliers to ensure the value chain remains strong.

What is the status of guarantee funds held under lien?

Interest earned on guarantee funds held under lien can be used in a variety of ways. In the case of Homeless International, the interest has been used to contribute to operating costs, to provision against loss and to increasing the size of the capital fund available to make new guarantee arrangements.

In the Slum Upgrading Facility, interest on guarantee funds will be used to support the functioning of the Local Finance Facilities. Because these facilities are being established to support wholesale rather than retail lending, the process will rely on intermediary agencies. Ensuring that these intermediaries have appropriate and adequate capacity will be crucial to ensuring success. Any interest generated will help the facilities build and support this capacity as well as buffer them against potential calls on guarantees.

Where do non-financial guarantees come in, and what risks do they cover?

We talked earlier about addressing the need to provide a “comfort factor” for banks and financial institutions. This means addressing non-financial aspects of risk that can be foreseen – and having the right team in place to handle risk that arises unexpectedly.

While the financial guarantee would be in place should the loan default, calling the guarantee is still the option of last resort. Banks want to know that there are other systems and assurances in place to deal with problems that arise – from political risk to management and governance risk to participation risk

In fact, experience suggests that many banks are less concerned about a financial guarantee and more concerned about other comfort factors to ensure the project will reach completion according to plan. Philip Brown from Citibank pointed out that a project needs to be ‘bankable’ – with sound business rationale and underlying economics. Who is the client? What is the project like? Does the guarantee provide more than money – technical support and commitment to get the project done? These are of critical importance – reminding us that there is much more to slum upgrading than the finance, and much more to guarantees than just the money.

It’s important to remember that a guarantee arrangement provides money, to be sure, but it also provides technical backstopping and project support. The due diligence conducted on the projects themselves is also a non-monetary guarantee.

For Society for the Promotion of Area Resource Centres, their support and management of a project is a major comfort factor for a bank. Dutch International Guarantees for Housing has had similar experiences, as their capacity acts as a guarantee in addition to the financial elements.

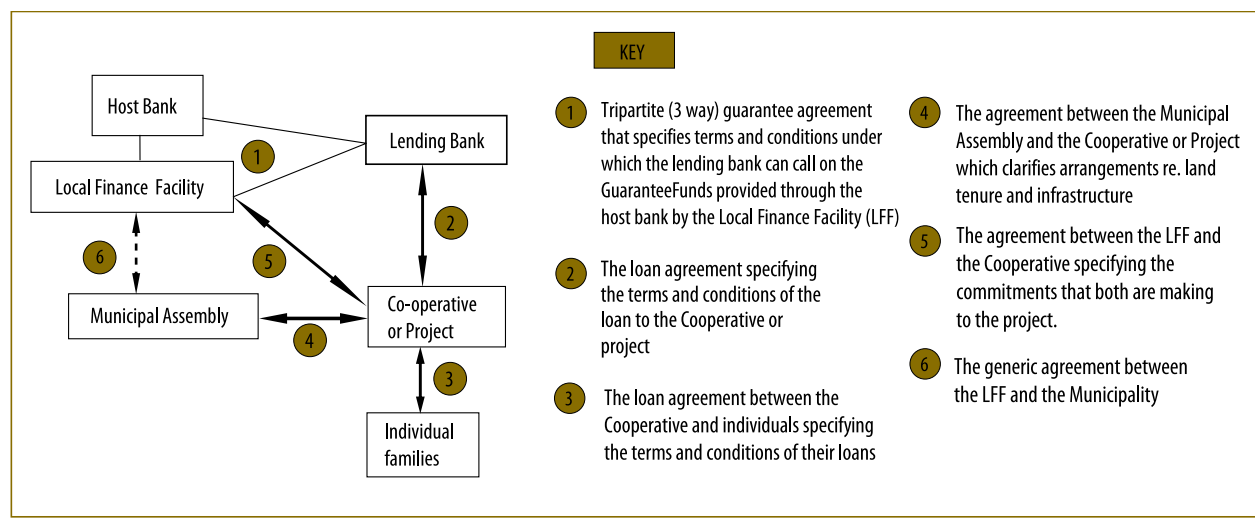
Slum Upgrading Facility aims to address this problem in a more institutionalized way – rather than project by project – through the establishment and operation of strong Local Finance Facilities. The facilities combine a financial guarantee with a variety of other comforts that come with having all the key people working together to ensure project success. This goes a long way in mitigating risks and in handling them as they arise.

What information is needed to develop and agree guarantee arrangements?

Agreements can sometimes be cobbled together in attempts to keep everyone happy. This can create confusion.

What kind of legal agreement/architecture is needed and how do different legal agreements work together? Bankers talk about back-to-back agreements, which essentially ensure that a series of specific agreements between the parties involved cover what is necessary in each case and do not contradict each other in a material way. There is a principle of “co-extensiveness” which is applied so that clauses in one agreement can make reference to clauses in another legal document.

Figure 1 The legal architecture of a guaranteed loan for slum upgrading



The graphic above shows the six agreements that make up a typical architecture of a guaranteed loan for slum upgrading. It begins with a three-way agreement between the host bank, the local finance facility, and the lending bank (1), stipulating cost (interest rate) and how risk will be shared (i.e., at what point the guarantee will be called upon). Agreement (2) stipulates terms and conditions of the loan with the project or group (also known as a local micro-finance institution). Agreement (3) is between individuals and the lending group – and it is at this point that the money is available for individuals. Agreements (4), (5) and (6) further strengthen the loan arrangements, as they outline the responsibilities of the municipality (for example for infrastructure provision) and of the local finance facility, to support this community effort. This combination increases the likelihood of success. It is complex, but experience shows that partners need clarity on their roles and responsibilities.

There can be disagreements regarding what is needed. For instance, when the first guarantees with Bank of India were being negotiated by Homeless International and the Integrated Village Development Project in India, the Bank of India headquarters wanted to use its own standard forms, which Homeless International did not consider appropriate. Greater flexibility resulted when the project persuaded the local Bank of India Branch to request that the London Branch of Bank of India be more flexible. There is a need to identify what constitutes a “material alteration” – a change significant enough to affect the legal standing of the agreement.

The Issue of Land: One of the assumptions often made is that bankers require evidence of clear land title in order to lend for housing. In fact, this may not be the case. In the Integrated Village Development Project case, the banks were confident that the households had de facto tenure security even if they did not hold formal title. They were much more concerned about patterns of saving and previous loan repayment that demonstrated a group’s capacity to repay. Even where banks do require evidence of formal tenure, this may not be because they want to enter into asset-based lending, but rather that they see secure tenure as evidence that a household will have a strong and long-term interest in repayment.

Finally, if a guarantee is to be used, how much is needed? This is something that is open for negotiation, but in every project, analysis would need to be done to determine what amount of guarantee would make sense. A higher level of guarantee can mean greater affordability for the community of a particular project, but it can also lock in money that would usefully be used as guarantee elsewhere. The Slum Upgrading Facility is developing a toolkit and a working paper on financial modelling and feasibility assessments as a tool to help with this kind of analysis.

What are the main negotiable elements in a guarantee agreement?

Elements that can be negotiated in a guarantee agreement could include the following:

- Step in rights – if payments are missed you have the option to step in and make them in lieu of the borrower so that you can control the rate of loss. You can also use the time agreed for stepping in to address problems that may exist in collection systems, project delivery and so on;
- Interest rate on any deposits;
- Interest rate on the loan including whether flat, reducing balance etc;
- Claw back period – for example if the final payment on a loan was made fraudulently you might be liable, and;
- Terms and conditions under which the guarantee can be called.

The amount of the guarantee agreed may be 100% of the loan amount but, more usually, the guarantee represents a percentage. This allows guarantee deposits to create leverage. The guarantee sum is normally held under lien during the period it is needed to secure the loan (i.e. it cannot be withdrawn or used for any other purpose which would make it unavailable to the lender in the case of failure to repay).

The percentage guarantee to be provided is negotiated as part of developing the agreement. In addition, the way in which the guarantee is applied needs to be agreed. A guarantor may agree to cover the “top slice” of the loan in which case, for example, if there is a 30% guarantee, the first 30% of loss on loan recovery is covered by the guarantor but any balance must be absorbed by the lending bank.

An alternative arrangement to top slicing is a “pari passu” arrangement, in which the loss, up to a specified limit, is split proportionately between the guarantor and the depositor. In the case of a 30% limited pari passu guarantee, the Guarantor would cover 15% and the bank 15% up to the total loss of 30% of the loan amount. The bank would be solely responsible for any losses above 30%. These proportions represent the ways in which those participating in the agreement agree to share the risks of the lending arrangement.

Where the bank providing the guarantee is also the lending bank, a bi-partite arrangement between the lender and guarantor is Slum Upgrading Facility. However, a tripartite guarantee agreement is

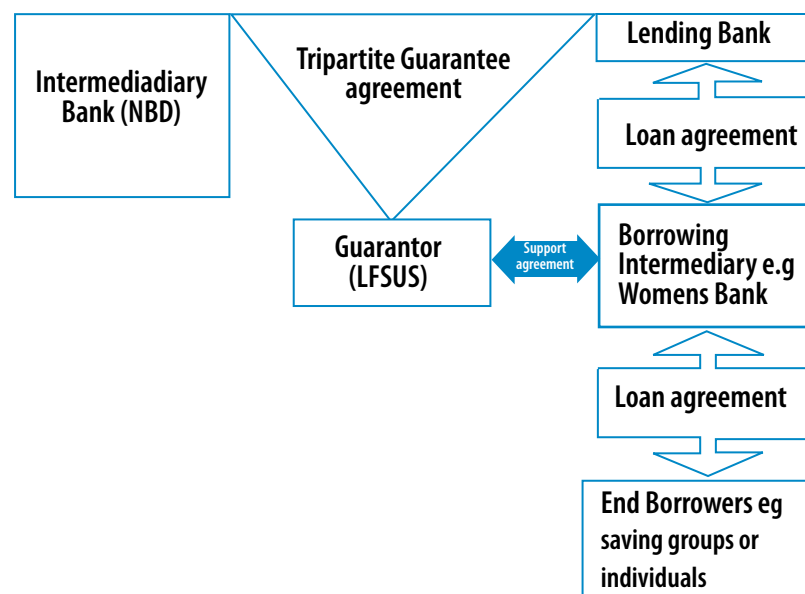
required when guarantee deposits are held by an intermediary bank rather than directly by the lending bank. A schematic summary of the architecture of a tripartite agreement is shown in Figure 2 below.

It should be noted that each guarantee arrangement is developed as a customised legal agreement. Although key elements will always be present, the details will vary.

At the Coventry workshop there was some discussion about the possibility of disseminating standardised guarantee agreements. In practice this can be problematic because:

- Agreements are developed to cover very specific arrangements and circumstances and cannot easily be applied in a “generic” manner;
- The work carried out in drafting such agreements is considerable and comprises intellectual property, and;
- Many of the definitions and conditions are linked to local legal requirements and governance practices;

Figure 2 Schematic outline of a Tripartite cash deposit guarantee agreement



What does a guarantee agreement look like?

All guarantee agreements will generally need to cover a number of standard headings which are described briefly below.

1. Definitions

The definitions will clearly specify what is meant by terms used in the agreement including:

- The borrower;
- The deposit;
- The deposit account;
- Encumbrance;
- Guarantee;
- Guarantee amount;
- Exchange rate (if appropriate);
- Guarantor;
- Loan, and;
- Loan agreement.

2. The Intermediary Bank will agree:

- What kind of account the guarantee deposit will be held as;
- How interest accrued on the account will be applied;
- How the lien held over the account will be accounted for;
- How balances held in the account over and above the amount required to guarantee the outstanding loan will be treated;
- The terms and conditions under which the guarantee deposits will be released from lien, and;
- The terms and conditions under which the funds held under lien will be “called on” and paid to the lending bank to cover the agreed percentage of losses incurred.

3. The Lending Bank will agree:

- The terms and conditions of the loan;
- Details of the banks nominated account to which sums payable by the intermediary bank should be paid;
- Specification of the procedures for recovery of loans including the length of default period which will trigger written notice to Guarantors and the length of default period which will trigger a call on the guarantee deposits held;
- The reporting obligations to the Guarantor;
- Acknowledgement of the limits of the Guarantor's liability, and;
- Acceptance of obligation to recover payments due and unpaid by the borrower by normal debt recovery processes in order to mitigate losses to the Bank or Guarantor arising from the default.

4. The Guarantor will agree:

- The timing and location of the guarantee deposit;
- Agreement to lien on the deposit being applied, and;
- Authorisation for the Intermediary Bank to make payments to the Lending Bank under the terms and conditions specified elsewhere in the agreement.

5. All three parties to the agreement will agree:

- The process for agreeing the period of the agreement and any significant changes or variations;
- How communication will be carried out between the parties;
- The process for assigning or transferring any rights or obligations under the agreement;
- The governing law and jurisdictions that will apply to the agreement, and;
- The form of notice for demands on the guarantee or extension of the guarantee term.

4 Institutionalising lending for slum and settlement upgrading

How do organisations institutionalise lending for slum and settlement upgrading?

“Micro finance has been successful because it operates at local level but operates according to global principles. One of the challenges of providing medium and long term finance for slum upgrading (as opposed to micro-finance for home improvement) is that this level of global learning and the creation of clear principles has yet to emerge. We are where micro-finance was twenty years ago.” Philip Brown, Citibank, Guarantees workshop participant

Slum upgrading is a difficult process and private sector lending for slum upgrading is a concept in its infancy. At the moment, this kind of lending seems to work on the basis of relationships and previous experience. The guarantee gearing that Society for the Promotion of Area Resource Centres is able to obtain is a good case in point – with their success over the years, they can now get loans with less than 10% guarantee gearing.

Beyond the issue of bankability itself, guarantees are seen by many, including donors, as complex instruments. Sometimes it can seem much easier to provide a grant or direct loan. Of course, that does not allow for sustainability or replicability in the same way a revolving guarantee can.

Institutionalisation of financing for slum and settlement upgrading within banks and other finance institutions takes time. It also involves changing perceptions and attitudes so banks see slum dwellers are potential markets. USAID refers to this process as “trying to change the discourse”. It is important to understand what motivates a bank to get involved. If it is short-term corporate social responsibility the impact is likely to be shallow and short, and certainly will not support slum upgrading “going to scale”. If, however, the bank sees its involvement as an investment in reaching a new market and a means of understanding that market, then senior executives can play an important role in pushing mid level executives to become involved.

Institutionalizing lending for slum upgrading requires support from the staff at the bank. Homeless International and Society for the Promotion of Area Resource Centres negotiated a very successful guarantee agreement with Axis Bank (formerly UTI Bank). When the person taking the lead role in negotiating on behalf of the bank left, however, his replacement had other priorities. Things can stall when there is no internal champion within a bank to function as a “legwork leader”, ensuring that the agreement gets through all the operational steps required and is understood by the range of personnel that need to review and advise on it.

Things can also get stuck when the risk department doesn’t know how to assess the risk. Where a legal department tries to squeeze the agreement into standard contracts that are not appropriate, or every eventuality must be considered in the legal documentation, progress can come to a halt. These are new working arrangements and require flexibility. As Ian Morris from Homeless International puts it, “It’s important to help people to talk; to make sure that the discussion penetrates down through the internal hierarchy of the bank and to nurture a spirit of financial partnership rather than protectionism”.

From the point of view of the borrower, the social sector needs to be more flexible in the way they communicate so that bankers can relate proposals to their own institutional rationale. Using new technology such as loan tracking can change attitudes and people can change their behaviour as a result. If people working in slum upgrading are going to have to deal with financial complexity on an on going basis, then they need to get used to the financial realities. This means having people able to negotiate with banks – a skill being developed and supported through Slum Upgrading Facility Local Finance Facilities.

And while banks are being asked to provide the finance, they often don’t know a lot about housing, especially the need for long term commitments. In the experience of Dutch International Guarantees for Housing, the most important thing is to understand the cash flow which means understanding the construction process and rental inflows. This lack of understanding has proved to be a particular constraint in Dutch International Guarantees for Housing’s discussions with regional development banks. Addressing it means developing working relationships with banks.

Ultimately, we need to move from credit provided on the basis of relationships to credit provided on the basis of systems and structures. Under what circumstances have banks embedded the process for guaranteeing slum upgrading loans in their internal business models and systems? The interview in the box below with ICICI Bank shows how the relationship between ICICI Bank in India and Society for the Promotion of Area Resource Centres has evolved to one of a relationship to a more institutionalized approach.

The good news is that banks copy from each other, so where the approach is seen to be working and where the market is sound and delivering a profit, replication is more likely to occur.

Interview with Anil Kumar of ICICI Bank, India

An interview between Ruth McLeod of Homeless International and Anil Kumar of ICICI Bank in September 2005 gives an insight into how banks are learning to work with the urban poor and their support non-governmental organisations, but also into how much further development of that relationship is still required.

HI: "How and why has ICICI Bank entered into a loan agreement with Society for the Promotion of Area Resource Centres?"

AK: "The first thing we look at is the implementer. The second is the project. Both have to be stand-alone viable. If you ask me why I deal with Society for the Promotion of Area Resource Centres it is purely because of their track record of implementing projects of various sizes, from Rs 50 million to Rs 430 million [approx 1 million USD to 10 million USD]. The size of the projects they are implementing has scaled up by a factor of 10 over the last five years and this has been achieved in very adverse areas. That's the first point. The second point is that they have a strong presence and relationship with the slum dwellers and this is particularly important because they work well with the communities affected by resettlement. This community linkage has been built up over 20 years, whereas their implementation competence as a builder has come up over the last five or six years"

HI: "How do you view the lending relationship that is being established, as philanthropic or as commercial?"

AK: "The scales are different. This Oshiwara II project is large-scale and we expect the money to come back. It's a commercial arrangement for us. Philanthropy would focus far more on social impacts. In a commercial arrangement there is also an impact on lives and on livelihoods but the most fundamental thing is risk: how effective you can be in lending money and getting your money back. This risk aspect is completely absent within a philanthropic approach."

HI: "Is this an entry point into a new market for ICICI?"

AK: "Yes. We see a large potential – not just in slum rehabilitation but also other areas such a micro-lending to individuals for housing. Also the potential for cross-selling of other financial products. There is a large unexplored market."

HI: "How does Society for the Promotion of Area Resource Centres differ from a large conventional builder or developer?"

AK: "A large developer works with a clear commercial orientation and brings in substantial liquidity, which supports their balance sheet. There's the support of a large commercial enterprise. In contrast, Society for the Promotion of Area Resource Centres is clearly not working with a profit motivation. A commercial project is clearly designed to have a profit margin which also takes care of any adverse moments with input prices and so on, whereas Society for the Promotion of Area Resource Centres is looking at the project with virtually no profit orientation so the margins may be very narrow or non-existent."

ContinuationInterview with Anil Kumar of ICICI Bank, India

HI: "What transition have you gone through as a banker in dealing with Society for the Promotion of Area Resource Centres?"

AK: "ICICI are now substantially more sensitized to working with non-governmental organisations as clients. Microfinance developments have meant that we might be working with 20 or 30 non-governmental organisations at any one time so it's clearly accepted to take non-governmental organisations as clients. Within ICICI we're working with around 65 non-governmental organisations, including Society for the Promotion of Area Resource Centres. However, almost all of them are in microfinance. So banks per se understand that non-governmental organisations can work in the field, with communities, and can deliver, so the initial mind set within banks has improved. Now banks have proven experience so they are beginning to be prepared to look at larger exposures. With non-governmental organisations the presentation of data has progressed considerably. Now the incoming data is being professionally managed and we are getting the precise data that we are asking for."

This dialogue demonstrates that, in India, there is potential for collaboration between the formal private sector and the urban poor and their support organisation, but it is also clear that there is much still to be done in deepening and widening this dialogue, in going beyond new projects to new products, and in taking the whole process to the scale needed if it is to have an impact across cities and across the country. (McLeod, Mullard, 2006. pg 146 – 148)

5 Some ongoing questions

Do these lending arrangements really benefit the poor?

Close to one billion people live in slums in the developing world, and the vast majority of those slum dwellers live on less than \$2 per day. But slum dwellers have access to resources of their own, and, as organized community savings groups have proven again and again, they also have the ability to save and repay loans.

What they do not have access to is formal credit. While this is changing in terms of micro-credit for livelihood loans in particular, longer term housing loans are simply not available, nor are wholesale loans to communities.

Lending for slum and settlement upgrading to reach the bottom 30% of the pyramid is exactly what many of the organisations at the Guarantees workshop are trying to do. The lending element is only a part of the package, and slum dwellers are certainly not expected to pay full costs for the upgrading. Slum upgrading as an entire package blends finance - through land and infrastructure provision by local authorities, for example, or mixed-use planning. Loans are only one part of the finance.

While lending for slum upgrading may not reach the poorest of the poor, it will address those at the bottom of the pyramid that are living in slums - which by definition contain a range of deprivations from overcrowding to lack of clean water to unstable structures. Slum Upgrading Facility and others are working on the premise that this type of lending arrangement is crucial in benefiting the poor.

Can guarantees help scale up slum and settlement upgrading, and how can guarantees leverage resources?

Figure 3 represents the “pyramid” concept popularized by C. K. Prahalad, showing the population in terms of income level. The top of the pyramid represents the (smaller) percentage of the population that are considered high income and low risk for loans and mortgages. The centre and bottom combined include the 4 billion people who are middle and low income. While not a precise graphic, it aims to show that generally, the high income groups are served by commercial banks using existing mortgage products, the middle of the pyramid are served through development banks and the kind of guarantees offered by USAID Development Credit Authority, while the bottom of the pyramid would

be covered by organisations offering first loss guarantees, such as Dutch International Guarantees for Housing, Homeless International and Slum Upgrading Facility.

Figure 3 Guarantee agreement



What degree of leverage can guarantees achieve and under what conditions?

As we have seen from the experiences of Homeless International, Society for the Promotion of Area Resource Centres and others, over time, the guarantee gearing ratio improves. Over time, a guarantee may only be required for 10% of the full loan amount, allowing low income borrowers far greater access to the capital pool. Eventually, after a group has produced an excellent repayment record, a lending bank may omit the requirement for a guarantee altogether. By taking the risk of first loss, or by sharing that risk, guarantees enable upscaling.

USAID Development Credit Authority talks about scaling up through reaching a new sector or entering a new geographic area. Their guarantee support can bring down risk and consequently reduce interest rates. The effect is that a USAID guarantee serves as a demonstration. It shows that this type of project finance, with this particular market and sector, can work. The private sector can then take over. The USAID Development Credit Authority has mobilized more than \$1.4 billion, with a default rate of less than 1%. The average leverage ratio is 30:1.

In terms of outcomes, guarantees and their application can serve to address market imperfection – typically that resulting from asymmetric information. People from all sides of the slum and settlement upgrading equation need to learn what is involved. Lending to people with low incomes can be profitable, even within the fundamental business rationale of a commercial bank. Members of savings associations can also become bank customers, even beyond the life of the loan.

One of the important lessons is that success breeds success. In India, the track record of the Integrated Village Development Programme and Society for the Promotion of Area Resource Centres in repaying loans has not only reduced the level of guarantee requirement but also encouraged more banks to become involved in lending to a non-traditional market.

Where organisations are guaranteeing concession tenders, there are also implications for infrastructure. For example, this means local groups can bid for big development contracts, such as water and sanitation provision, potentially reducing the costs and strengthening the economic benefit to local communities from the construction process.

Participants at the Guarantee workshop felt it was important that guarantees not be a part of the corporate social responsibility (CSR) section of the bank. While CSR may be a useful way “in the door”, it does not change the way a bank does business, and experience has shown that if a loan for slum upgrading is seen as CSR, it will not go to scale.

What are the costs and prices of guarantee arrangements?

Developing guarantee arrangements can be extremely time consuming and costly, and this is especially true where they are being used for the first time. Often it is difficult to rapidly institutionalise new arrangements and this becomes particularly problematic when there are frequent changes in personnel.

Homeless International has not charged for guarantees as it has only provided guarantees for projects implemented by organisations with which the agency has had very long term relationships. The guarantees provided are closely related to the wider social development programmes implemented within these on-going relationships. In effect, the quality of the long term relationships functions as a kind of intuitive credit rating. Homeless International is, however, considering the option to charge a nominal fee at the end of a successful project as long as the cash flow on that project proves positive.

USAID applies an origination fee, which is a one-off, up-front amount to ensure a “reality check”. That way, banks that apply for a guarantee show that they are serious. There is also a utilisation fee applied twice yearly. This is a percentage fee on amounts actually guaranteed so that banks don’t keep guarantees in place when they are not needed. Both these measures control for issues of moral hazard.

Dutch International Guarantees for Housing applies a premium for currency risk using a formula that adjusts the premium on an annual basis linked to fluctuations in rates over the previous three years. The premium is recalculated on an annual basis.

Are new forms of legal bodies required to develop and manage this new way of working?

If an organisation wants to provide a guarantee for a loan it must have the legal powers to do so. Normally this power is specifically specified in the legal registration documents for the organisation. In the case of Society for the Promotion of Area Resource Centres, a non-governmental organisation, establishing a section 25 company (called Nirman) that was legally able to deal with finance and guarantees was necessary. For Slum Upgrading Facility, Local Finance Facilities in Ghana, Indonesia and Sri Lanka are all legally registered not-for-profit companies with the legal remit to provide guarantees of this kind at the national or city level.

How are these arrangements regulated and what is the role of central banks?

Banks are regulated under banking law with central banks playing a key regulatory role. As financial markets have become increasingly globalised, the need for international regulation and guidance has been increasingly recognised. At the time of writing this issue is a matter of major international interest and concern in the context of an escalating global financial crisis.

Basel II is the second of the Basel Accords, which recommendations banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, which was initially published in June 2004, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Advocates of Basel II believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse.

In practice, Basel II attempts to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

In practical terms, regulatory requirements can considerably constrain and delay potential lending for housing improvement and slum upgrading. For example, Dutch International Guarantees for Housing found that the level of control exerted by the Central Bank in South Africa led to considerable delays.

The situation in the Ukraine was also difficult. In the latter case it helped to be able to use a local branch of ING Bank supported by the ING headquarters in the Netherlands.

However the issue of appropriate regulation is important and developing appropriate guidelines for this new area of lending will be an key step for practitioners to take in the near future..

6 Conclusion

Guarantees for community-led slum and settlement upgrading projects are complex and new, but they can work. Experience, combined with enthusiasm and the growing need for solutions that will take slum upgrading to scale, is starting to bear fruit. More slum upgrading projects and programmes use guarantees as a tool in their upgrading approach.

Guarantee providers in development will continue to learn and share knowledge around the use of guarantees for pro-poor slum upgrading. We close this working paper on Guarantees with a collection of tips from those in the guarantee field.

Top tips from the field

- Be realistic about what can be leveraged with a new approach;
- Be clear from the beginning what is negotiable and what is not. Show this clearly in the guarantee agreement format. This helps people get used to the process, which in turn enhances the options for scaling up;
- Understand the investments that need to be made to create a track record;
- For each activity, identify the real objective in the short, medium and long term including the aim of scaling up through replication;
- Recognise that project development and the negotiation of project financing takes time. Dutch International Guarantees for Housing estimates quite quick project development to take 2 to 3 years. Financial structuring typically takes 18 months. Things can, however, be sped up if the level of guarantee provided is increased. Development Credit Authority deals can take anywhere from 6 months to 5 years;
- Be opportunistic! In reality, you usually don't have time to do a perfect plan in advance. Start, then do the cash flows, then go to the bank;
- Recognise that in situ developments can take longer than greenfield sites;
- Withstanding bribery can lead to prolonged delays in implementation and payment, particularly on government related schemes;

- Show that the project is viable and show stakeholders that you can manage the different risks;
- Don't go into a bank to negotiate a loan and immediately offer a Guarantee;
- Be careful about country law as you need to be able to enforce conditions;
- Beware of banks wanting to use their own formats;
- Accept some messiness up front – if you wait to get everything completely tidy nothing will ever start. There are strong elements of faith in developing this kind of arrangement;
- Clarify step in rights;
- Don't fall in love with the deal – be ready to walk away or make changes. This is not always easy for agencies with social development objectives;
- Always bear in mind that banks should take their share of the risk;
- Guarantee providers should strive to effectively reduce and even phase out guarantee support when it is no longer needed, and;
- Keep it as simple as possible.

Presentation summaries

This paper developed out of a meeting on Guarantees held 6 – 7 August 2008 in Coventry, U.K., hosted by Homeless International and the UN-HABITAT Slum Upgrading Facility. The meeting was an attempt to bring together all the main players involved in guarantees for development, to share experiences and try to discover common emerging 'good practice' and glean ideas for the way forward.

Presentations were made at the meeting by Homeless International, Society for the Promotion of Area Resource Centres, USAID Development Credit Authority, Dutch International Guarantees for Housing, Swedbank, Guarantco, and The UN-HABITAT (Slum Upgrading Facility and the Experimental Reimbursable Seeding Operation). While many of the discussions were captured in the main sections of this paper, the following section provides a short summary of the presentations of each of the organisations listed above.

For any further information from any of the organisations, please don't hesitate to get in touch through the websites and contacts provided.

Homeless international

Presented by Mr. Ian Morris, Homeless International

Established in 1987 by the UK social housing sector, Homeless International (HI) has a vision of Equitable Cities. The focus of HI is on supporting the delivery of housing and related infrastructure for the poor in urban areas. They accomplish this through a range of financial and non-financial support, increasingly in the area of “financial services”. Homeless International currently works in a dozen countries in Africa and Asia. HI is working towards a point where the capacity and reputation of local partners is built to a point where they are able to independently access the resources and support required on a sustainable basis.

The “Homeless International Guarantee Fund” was established in 1994 using long-term repayable Contributions from the UK social housing sector, as well as donations. The Fund is used to secure loans from local banks to implementing partner organisations, and in some cases, it is used to encourage banks to lend for the first time to low income people. Guarantees are arranged on a bi-partite or tri-partite basis, and the projects supported are typically medium – high risk. The value of the Fund currently stands at over 1 million USD

Table of Experience to Date

Date	Level and type of guarantee	Deposit (monetary equivalent)	Banks involved	Partner organisation	Purpose of loan	Current status of guarantee
Mid/late 90's	>100% FLDG	>£150k	HUDCO HDFC SIDBI	Youth Charitable Organisation (YCO)		Called in
2000	>100% FLDG	US\$50k	El Fondo de la Comunidad	Fundación Pro-Habitat	Constructing/improving houses in Cochabamba, Bolivia	Released

Guarantees for Slum Upgrading

Date	Level and type of guarantee	Deposit (monetary equivalent)	Banks involved	Partner organisation	Purpose of loan	Current status of guarantee
2001	25% FLDG	£36.6k	Bank of India	Integrated Village Development Project (Integrated Village Development Project)	Constructing/improving around 500 houses in Tamil Nadu, India	Released
2003	20% FLDG	£50k	Citibank	Society for the Promotion of Area Resource Centres (Society for the Promotion of Area Resource Centres)	Constructing an in-situ slum upgrading project for >200 families in Dharavi, Mumbai, India	Released
2004	25% FLDG	£65.6k	Bank of India	Integrated Village Development Project	Constructing/improving around 1,000 houses in Tamil Nadu	Released
2004	Equivalent to 11% FLDG	£85.3k	National Housing Bank (NHB)	Nirman (construction and finance arm of Society for the Promotion of Area Resource Centres)	Constructing an in-situ slum upgrading project for around 150 families Dharavi, Mumbai, India	Still in place
2007	10% FLDG	£62.9k	Bank of India	Integrated Village Development Project	Constructing >5,000 toilets in Tamil Nadu	Still in place

Date	Level and type of guarantee	Deposit (monetary equivalent)	Banks involved	Partner organisation	Purpose of loan	Current status of guarantee
2008	10% FLDG	£69k	AXIS Bank	Nirman	Constructing of the second phase of the Mumbai Sewage Disposal Project (MSDP) benefiting >30,000 families in Mumbai	Still in place

Experience to date

Case study 1 (Bank of India) - Reduction of guarantee-to-loan ratio from 25% to 10%; Introduction of Homeless International's bi-partite guarantee template, and subsequent resistance to using it from Bank of India; Difficulties in dealing with Bank of India, including with and between branches in India and London.

Case study 2 (AXIS Bank) - Loss of lead contact at AXIS Bank and subsequent complete lack of hand-over, resulting in a delay of >8 months; Request for a meeting in the early stages with the various people that held posts that often proved to be obstacles. Getting legal advisers on both sides to communicate with each other directly, and to do so in the right spirit; Difficulties in dealing with AXIS Bank.

Plans and thoughts for the future

- Grow the size of Homeless International's Guarantee Fund;
- Explore developing an asset-based guarantee model, similar to Dutch International Guarantees for Housing (Dutch International Guarantees for Housing);
- Explore better co-ordination, co-operation and collaboration between/with other guarantee providers;
- Continue to ensure that banks are taking appropriate levels of risk;
- Explore charging implementing partner organisations a nominal fee for our guarantee service where possible, practical and appropriate, and;

- Start providing guarantees to new and existing implementing partner organisations outside India

Reflections

- The overall aims of international development and banks are typically not a very natural fit, yet there is a clear need to and interest in forming partnerships;
- Lending directly to/for the poor is not something that banks are generally known for, but the idea has increased in popularity amongst banks;
- It is very unlikely, however, that this means that banks will start lending directly to the poor;
- Banks will still obviously be seeking to maximise their profit and minimise their risk, and so will be looking for capacity, reputation and credit rating, and;
- Guarantees can play a useful role in bridging the building of this capacity, reputation and credit rating, and/or in allowing financially risky but socially strategic projects to go ahead.

For more information on Homeless International, please visit the website www.homeless-international.org or send an email to info@homeless-international.org.

Society for the Promotion of Area Resource Centres

Society for the Promotion of Area Resource Centres is a non-governmental organisation that has been working with slum dwellers across India for the past 25 years and is now in 72 Indian cities. Society for the Promotion of Area Resource Centres is the “formal part” (a registered charitable society - Section 25 company) of an alliance with two unregistered partners - a national slum dwellers federation and a women’s bank.

Society for the Promotion of Area Resource Centres’s main activities are:

- community mobilisation around enumerations, exchanges, savings and credit;
- rehabilitation and resettlement of people affected by projects of the government (Society for the Promotion of Area Resource Centres has helped shift more than 23,000 families successfully);
- construction projects - housing and sanitation (these projects are community led, designed, implement and managed. The agenda is community driven.

Samudaya Nirman Sakayak (SSNS)... Or just “Nirman”

SSNS is a not-for-profit company set up by Society for the Promotion of Area Resource Centres and the National Slum Dwellers Federation (NSDF). Its mandate is to undertake construction projects (housing and related infrastructure) for the Alliance, and it is commonly referred to as “Nirman”. Large scale projects that have been proven to be replicable and socially and financially viable are routed through SNSS. SNSS, as a company, is more able to get loans and offer guarantees.

Many government subsidies exist to help the poor but remain untapped because commercial organizations ignore profitable projects for the poor due to an opportunity for higher returns elsewhere or are unable to negotiate effectively with the Non profit sector. Society for the Promotion of Area Resource Centres believes that government agencies do not have the mechanism to deliver these subsidies. Non-Profits must fill this gap. They need access to financing to undertake economically viable projects to demonstrate that these are financially viable, scalable and replicable.

Society for the Promotion of Area Resource Centres operates in such a way that it participates in government tenders for development schemes that affect the poor. These projects are normally designed by bureaucrats who generally have no idea what the poor require. This gives Society for the Promotion of Area Resource Centres a chance to implement and re-design the scheme to meet the requirements of the poor. We encourage State Agencies to involve community participation and break the nexus of the public works dept and the private contractor.

Society for the Promotion of Area Resource Centres continues to explore new models/mechanisms and plan for city-level development: Influencing policy at the local, state and national level.

Society for the promotion of area resource centres sources of funds:

Society for the Promotion of Area Resource Centres uses mixed income streams of grants and debt as follows:

1. Government Reimbursement for Community projects;
2. Market-based subsidies;
3. Grants and Donations and Revolving Funds, and;
4. When a model has proved sustainable/viable, wherever any gaps remain, Loan Funds fill up gaps in cash flows, drawing in the banking sector and formal institutions.

Types of guarantees

Municipalities/Agencies need performance security when they give us contracts.

Lenders look for security when they part with funds to limit the Bank's risk as a lender. Lenders like to have another organisation independently examining the proposal. There is an absence of normally-used parameters – balance sheet indicators for example. Many of the projects cannot offer any collateral e.g. Sanitation Projects where there is no transfer of title. Banks tend to look for a strong organization rather than a strong project and large profit margins rather than sustainability. They have no way to either measure or give credit for the positive social impact. Not-for profits have no capital and not-so-strong cash flows and are dependant on market and state based subsidies. The absence of assets and cash collateral of the not-for-profit equals discomfort!

Need for guarantees

In the absence of traditional security, banks find it easy to fall back on a guarantee mechanism. By asking for a guarantee, the lender is giving himself a “vague” feeling of comfort. There is no clear reason why a bank studying and evaluating a proposal should ask another bank or financing institutions to take up the risk if they feel the project is sound. The result is that non-governmental organisation faces the task of undergoing evaluation at multiple levels. One more institution, perhaps of higher credibility and standing, evaluates the proposal – Maybe the guarantor is more familiar with the history, credibility and background of the not for profit or community organisation.

With a guarantee, boards and auditors can be more easily satisfied. Of course, you cannot mortgage units - that would mean pushing poor people on the street. Only lien on Transfer Development Rights or sale units which are built after rehab and inflows come at the end of the projects. The availability of a guarantee amount as first recourse will increase the period for which the asset need not be classified as non-performing.

Performance security

Clients also look to secure future progress of their projects through Performance Guarantees. It is felt that few non-governmental organisation/not for profits have the organizational/management skills to undertake large development projects. The success of Society for the Promotion of Area Resource Centres means that we have proved our skills in this area, and that allows us to participate in govt tenders for development schemes that affect the poor.

Society for the Promotion of Area Resource Centres has been availing of loans to fill in gaps in cash flows. Linking the poor to finance institutions and giving them a chance to influence state policy and schemes. Community led projects need to be demonstrated – as being viable, and replicable and can be taken to scale

Markandeya-Hudco-Selavip

Borrower	Lender	Guarantor
Markandeya [1991]	HUDCO	SELAVIP
Collateral		None
Guarantee As % age of loan Amount		150%
Guarantee Secured By		1.5 times loan amount placed in FD with a third party Bank
Risk Sharing		None (Guarantor takes the Hit)

Rajiv Indira-Citibank-HI

Borrower	Lender	Guarantor
Rajiv Indira [1998]	CitiBank	HI
Collateral		None
Guarantee As % age of loan Amount		20%
Guarantee Secured By		Letter of Comfort
Risk Sharing		None (Guarantor takes the Hit)

BSDP-UTI-HI

BORROWER	LENDER	GUARANTOR
BSDP [2000]	UTI BANK	HI
Collateral		10% margin money in FDs
Guarantee As % age of loan Amount		100% guarantee for (a) advance of 20% of project cost] (b) performance guarantee [15% of project cost]
Guarantee Secured By		Letter of Comfort from HI
Risk Sharing		None (Guarantor takes the first 20% hit)

Bharat Janata-NHB-HI

BORROWER	LENDER	GUARANTOR
BHARAT JANATA [2004]	NHB	HI
Collateral		Lien placed on Transfer Development Rights and Sale Units
Guarantee As % age of loan Amount		16%
Guarantee Secured By		Deposit Placed by HI with a third party bank
Risk Sharing		Guarantee is invoked in case of default

Oshiwara II-ICICI Bank-USAID

BORROWER	LENDER	GUARANTOR
OSHIWARA II [2006]	ICICI BANK	USAID
Collateral		Charge on Recievables
Guarantee As % age of loan Amount		25% of loan amount + 10% premium on exchange rate variation
Guarantee Secured By		Guarantee agreement between USAID and ICICI bank
Risk sharing		50% Risk sharing with guarantor

MSDP II-AXIS-HI

BORROWER	LENDER	GUARANTOR
MSDP II [2007]	AXIS BANK	HI
Collateral		Lien on Future Cashflows
Guarantee As % age of loan Amount		Guarantee By HI for 10% of loan
Guarantee Secured By		Guarantee By HI to AXIS and ICICI bank
Risk Sharing		Guarantee to be invoked in case of default

Evolution of financing model

- Grants to set precedents on housing and sanitation;
- Scale by seeking contracts with state institutions;
- Increasing capacity to blend different funds to produce scalable housing and sanitation; and;
- Precedent Setting” - demonstrate they are do-able; explore designs, sustainability and viability; demonstrate policy changes required. Society for the Promotion of Area Resource Centres current models and strategies emerged from initial projects.

What has Society for the promotion of area resource centres learned over the years?

- There is no systematic procedure in place for accessing funds or guarantees
- There is no procedure to define the amount of guarantee required
- There is no way precise way to determine what to expect in terms of risk sharing - top slice, pari passu, equal, etc

There are difficulties.

Usually, the not-for-profit brings together the Guarantor and Lender – they have never met before this. In this “arranged Marriage” the Financial Institution and the Guarantor are both familiar and confident with the project, but have to get “friendly” with each other. And guarantors and lenders have different expectations. The not for profit is caught in the middle – to try and get both sides to see the same picture.

In addition, guarantee commissions add to the cost of funds for the not-for-profit.

Trying to Breakthrough - what is involved?

- Sharing information – but it must be relevant. Knowing what information is required;
- Understanding the legal constraints under which all parties are subjected, and;

- Bringing all parties together at the start so that the project parameters, risk mitigating strategies, accountability are transparent.

Conclusion

This is a huge opportunity whose time has come, but it will not work if seen in micro credit mode. It is time to streamline the process and develop transparent credit rating structures. We need to designing new models that work for a variety of projects.

While formal financial institutions will lower the income percentile bars, our type of solutions only can reach the bottom 30%. Developing institutional capacity to dialogue negotiate and do business with such hybrid organizations such as Nirman (an arm of Society for the Promotion of Area Resource Centres that is a section 25 company and able to deal with finance and guarantees) will open that space.

For more information on Society for the Promotion of Area Resource Centres please visit the website at: www.SocietyforthePromotionofAreaResourceCentresindia.org

USAID Development Credit Authority: Using credit guarantees for slum upgrading

Presented by Ms. Alison Eskesen, office of development credit, USAID

The USAID Development Credit Authority (Development Credit Authority) is:

- Legal Authority for USAID to issue Credit Guarantees;
- Guarantees backed by US Treasury;
- True risk-sharing with private sector (never more than 50%);
- Fees to encourage utilization;
- Currency mismatches discouraged;
- No sovereign borrowers, but can cover sub-sovereign: states, municipalities, cities, and;
- Development Credit Authority most effective when linked to TA or Policy Reform.

The guarantee impacts have been

1. Untapped liquidity has been mobilized in the banking sector - more than \$1.4 billion has been made available since 1999, and the default rate is less than 1%;
2. Complements technical assistance and policy reform;
3. It is a Cost effective tool with an average leverage ratio of 30:1, and;
4. There has been a market demonstration effect, and catalyst for growth of local credit markets in places like Morocco, India and South Africa.

Impacts on bank behavior

Al-Amana and Zakoura (Morocco):

- Created in 1997 with significant investment from USAID funds and technical assistance;
- Both are MFIs that used guarantee commitments from USAID to access funds to onlend for urban housing microloans, and;
- Development Credit Authority guarantees increased the MFIs' creditworthiness and they can now access financing at better terms, which they can pass on as better terms to their clients.

Tamil Nadu (India)

- USAID guaranteed a pooled financing mechanism to provide investment funds to small and medium urban local bodies to implement water and sanitation projects, to benefit low income populations;
- Guarantee from USAID improves investment grade rating;
- Enables small and medium municipalities to access more financing than they could on their own, and;
- Market demonstration effect for future pooled financing structures.

Greater Johannesburg Municipal Council (South Africa)

- USAID provided guarantee commitment to GJMC, which used it to secure loan from ABSA Bank to finance urban upgrading services;
- In June 2004, halfway through the loan repayment, GJMC obtained cheaper financing from capital markets and pre-paid its debt to ABSA Bank

Guarantee variables

1. Development Objectives: How does the guarantee achieve USAID's development objective?

Examples

- Enable low-income households to obtain affordable housing (Mexico, Nigeria, Morocco);
- Increase access to health services (Nicaragua, Philippines), and;
- Expand and improve water and wastewater service delivery to underserved populations (Kenya, Egypt, India, Philippines).

2. Terms of the guarantee

- Financial partner can be banks, institutional investors, Non-bank financial institutions;
- The borrower can be municipalities, private utility providers, MSMEs;
- Fee structure: There are two types: origination and utilization;
- The term is between 2 to 20 years, average is approx. 7 years, and;
- There is a minimum loan tenor to encourage long-term lending.

3. National and regulatory contexts

Development Credit Authoritys work best when accompanied by supportive policy and regulation, which are often a focus of USAID's technical assistance programs. For example: Recent legislation in Albania allows municipalities the ability to borrow; the Development Credit Authority will guarantee loans so that municipalities can invest in infrastructure projects.

However, sometimes Development Credit Authority's fail for the same reason! For example: A Development Credit Authority in Egypt was designed to complement legislation allowing private water enterprises to service municipalities but the law was never enforced so the Development Credit Authority was not utilized.

Guarantee structure and Fees

USAID charges two fees that are designed to make sure the financial institution uses the guarantee strategically:

1. Origination/Commitment: A one-time fee paid upfront, ranges from 0.25-2.00%. This ensures that the guarantee facility size is realistic for the partner institution, since it pays the fee as a percentage of facility amount.
2. Utilization: paid on outstanding utilized amount, ranges from 0.25-2.00%. This ensures that the partner institution thinks hard about what is placed under guarantee coverage; encourages additionality.

USAID provides 50% pari-passu guarantees to cover realised loss. They will pay out before full recovery of collateral but expect repayment once collateral has been recovered. They rely very heavily on the lender to assess and monitor loans and are very light on reporting requirements. Their loan portfolio mainly covers guarantees where the end borrowers are unknown but within a defined sector – for example, in the IT service providers.

For more information on USAID Development Credit Authority, please visit the website at: http://www.usaid.gov/our_work/economic_growth_and_trade/development_credit/

SwedBank: Perspectives from a banker

Presented by Mr. Stig Jonsson, Swedbank

Financing in general

- A loan must be paid back;
- All financing must be based on the borrowers repayment capability;
- Securities should be seen as a form of insurance if something unexpected occurs;
- The more you know about your borrower and the more experience you have of the borrower the less you will need the security/"the insurance";
- On the other hand, the less you know about your borrower and the less experience you have of the borrower the more you will need the security/"the insurance", and;
- An insecure banker tends to overreact – "demanding both belts and braces".

Guarantees

- Issuing guarantees are more complicated compared to loans as there are always at least three parties;
- The length/expiry date of a guarantee might be difficult to measure;
- Can be issued in different forms, from limited to amount and claim to be made after all legal actions have been finalized and loss been proved - up to on demand guarantees with full coverage of principal, accrued interest and costs;
- While 99,99% of loans are standardized and issued by bank officers at local branches – 100% of guarantees are issued by bank lawyers, and;
- An insecure/doubtful banker will most likely demand an on demand guarantee with full coverage of interest and costs.

How a banker values the guarantor

- A banker will feel more comfortable should the Guarantor be a well established institution where there are no doubts in fulfilments of commitments made, and;
- A Guarantor having issued a large number of guarantees – spreading the risks – is less risky compared to a Guarantor with very few guarantees.

Local Finance Facility as guarantor

- The Local Finance Facility is a special vehicle established for the purpose to finance / guarantee one or more Slum Upgrading Facility-projects;
- Its only strength or economic body comes from grants injected – primarily through UN-HABITAT;
- A combination of a fairly weak guarantor with a borrower who is new and unknown will make the banker even more insecure and hesitant;
- There is a risk that bankers will require cash deposit to cover not only the principal amount but also interest and costs;
- In any case the Local Finance Facility will have to take into account interest and costs covering the whole commitment should an on demand guarantee be requested;
- All funds available might thus not effectively be used in the Slum Upgrading Facility-projects, and;
- There is also a risk that the leverage element, at least initially, will be very limited since the funds are tied up in cash deposits.

It is paramount to get the banker on board in a very initial stage. The banker will have to be assured of the sustainability of the project, that the timetable and costs will hold, and that all parties concerned are committed to the project.

For more information on Swedbank, please visit the website at: www.swedbank.com

Dutch International Guarantees for Housing foundation

Presented by Mr. Erik Beijer, Managing Director, Dutch International Guarantees for Housing

“Financing social housing based on guarantees of Dutch Housing Associations”

The social housing sector in the Netherlands is a one billion euro business and the sector has a massive asset base and annual turnover. Of 450 housing associations in the Netherlands around 30 are managing housing development projects.

“A” rated housing associations have been able to contribute to a Housing Guarantee Fund which has in turn provided “AAA” rated guarantees to Dutch International Guarantees for Housing so that the agency can borrow from banks in the Netherlands and on-lend to housing development projects. Important intervention was promoting legislation allowing housing associations to use 0.3% of their balance sheet each year. This amounts to 30 million euro annually from the sector. In theory, this could be used to provide a 100% guarantee securing 30 million euro annual repayment of capital and interest on long term loans equating, dependent on the term and interest rate applied to the loan, to lending potentially 400 million euro.

Dutch International Guarantees for Housing value added is very much their background and understanding of housing. Dutch International Guarantees for Housing experience is they can operate “business to business”, and are not dependant on local government or banks, although they do depend on local institutions that can handle the projects themselves. Upscaling is possible, as Dutch International Guarantees for Housing takes the risk of first loss, so others can handle other parts of risk.

The banks lend to Dutch International Guarantees for Housing on a twenty to thirty year basis. They have their own assessment processes and credit committees. Dutch International Guarantees for Housing provides guarantees for individual projects but are now looking at a collateral pool. Because Dutch International Guarantees for Housing receives 100% guarantees the agency itself takes no risk whatever. This makes it very different from the Homeless International arrangement. Dutch International Guarantees for Housing is dependent on local institutions and legislation. These factors determine whether or not Dutch International Guarantees for Housing can work in a particular country. e.g. Dutch International Guarantees for Housing works with Habitat for Humanity in Eastern Europe. Habitat for Humanity provides a local capacity that helps Dutch International Guarantees for Housing to overcome local institutional problems.

For more information on Dutch International Guarantees for Housing please visit the website at: [www.Dutch International Guarantees for Housing.nl](http://www.DutchInternationalGuaranteesforHousing.nl)

GuarantCo

Presented by Douglas Bennet, Senior Guarantees Executive, GuarantCo

GuarantCo's business is credit enhancement of local currency debt issuance by the private, municipal and parastatal infrastructure sectors in lower income countries. It is an initiative of the Private Infrastructure Development Group ("PIDG" www.pidg.org)

GuarantCo's products are as follows

- Partial credit guarantees - generally on demand and unconditional – on a first loss pari-passu (up to 80%) basis;
- Partial risk guarantees covering default risk due to specific events such as construction failure, and risk guarantees to back up performance bonds issued by banks;
- First loss cover for senior, mezzanine or sub debt; maturity, coupon or principal strips;
- Other methods of risk transference considered (e.g. insurance / reinsurance or CDS / derivatives), and;
- Prohibited from offering political risk insurance as a stand alone product but political events can be covered by the above products

Eligible clients are as follows

- Private sector project companies undertaking greenfield projects or expanding existing facilities;
- Municipal infrastructure if funded largely through user fees (or ring-fenced structure providing satisfactory security);
- Parastatals if privatisation is planned (or case by case if operations are along commercial lines), and;
- Refinancing of existing projects if cross-border financing is substituted by local currency debt

Eligible sectors are listed below

- Urban / social infrastructure (incl. housing);
- Energy generation, transmission and distribution (incl. natural gas except extraction);
- Water/waste management services;
- Transportation (mainly fixed installations);
- Telecoms;
- Infrastructure component of agro-industrial and mining projects, and;
- Basic industries that impact positively on development of infrastructure / promote economic development (e.g. steel, cement, biofuels etc).

GuarantCo focuses on “good projects in poor countries rather than poor projects in good countries”. Focus countries are DAC I and II countries and defined by the OECD as “least developed and low and lower middle income countries” - per capita income up to \$3,255 (in 2004). That includes most of sub Saharan and North Africa, parts of the Middle East (Iraq, Jordan, Palestine, Syria, Yemen), most of Central and Southern America and parts of Asia e.g. Indian sub continent, Central Asia, Vietnam, Laos, Cambodia.

GuarantCo has resources that include initial capital of \$73m. Increase to \$100m likely in late 2008. The average participation in a single project is \$5m - 20m (initial period), with transaction tenor up to 15 years. One third of GuarantCo’s capital is committed. Larger requirements can be syndicated to other investors if requested (up to \$100m). The portfolio targeted at \$300 - 500m in the medium term. GuarantCo has technical assistance funds e.g. up to \$500k per initiative / project, but most are likely to be \$50,000 – 250,000. Guarantee pricing will vary according to risk but it is unlikely to be below 1.75%pa (do not wish to displace commercial risk takers)

Conceptual issues around guarantees are as follows:

- Lack of understanding of guarantees for projects and their advantages (and disadvantages);
- Viewed as complex compared to direct lending;
- Lack of commitment, in part due to the issues above, and;
- Regulatory Issues may provide an additional hurdle.

There are also local currency exchange issues, as GuarantCo is a local currency guarantor (to promote local currency funding), and accepts exchange risk, if rates change. Foreign exchange concerns arise in:

- Maximum Guaranteed Amount or Cap;
- Payment Requirements to meet a call under the Guarantee, and;
- Crystallisation Issues.

GuarantCo payment procedures:

- On demand or conditional;
- Any requirement to prove loss or to have pursued repayment;
- Loan written off;
- accelerated debt;
- Waiting periods and notifications, and;
- Repayment of full amount following acceleration or maintain repayment schedule.

Extent of Guarantee:

- Full Indemnity or cover for Specific Amounts;
- Interest;
- Principal (including accelerated amounts?);
- Fees;
- Default interest;
- Expenses;
- Percentage Covered;
- Timing;
- Length of underlying loan or bond;

- Include clawback period, and;
- Restriction on claim period following a non-payment event.

Fees and Pricing:

- Potential overlap on fees between the lender and guarantor – up-front and commitment/stand-by fees;
- Failure by local lender to recognise and price project risk compared to guarantor risk, and;
- Credit rating – key concern for beneficiary when pricing for liquidity.

Funding Tenor Extension:

- Tenor of local bank lending often constrained due to absence of longer tenor deposits (asset / liability mismatch);
- Either internal treasury or external regulator constraint;
- GuarantCo is prepared to offer “put” options to local lenders:
- guarantee can be called for liquidity reasons (as well as credit reasons);
- Could cover funding risk beyond a certain date or during times of unusual volatility;
- Only offered in conjunction with partial risk or credit guarantees (ie not standalone), and;
- If tenor is a credit issue then GuarantCo can cover later maturities.

For more information on Guarantco please contact

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or

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Or visit the website on: www.guarantco.com



Sample Transactions



Completed transactions

Celtel Kenya

- Partial Credit Guarantee of a \$50m equivalent 5 year bond issue for mobile phone network expansion. Only the third commercial bond issued in Kenya and largest at that time

Celtel Tchad

- 100 % 6 year guarantee of \$14m equivalent bank loan. Local lenders, Afriland First Bank and BDEAC, also lent \$20m equivalent without guarantee

Mabati Rolling Mills Kenya

- Partial guarantee of a \$30m equivalent 9 year bond issue to finance a steel rolling mill to supply low cost roofing materials

Alaf Limited Tanzania

- Partial guarantee of a \$14m equivalent 9 year bond issue to finance a steel products manufacturing plant

Mandated transactions

- Guarantee for a \$75m equivalent contingent cost overrun facility for an oil refinery in Southern India
- \$15m equivalent 15 year partial guarantee to finance a new private sector utility on Bugala Island, Uganda
- \$12.5m equivalent 15 year loan guarantee for a gas fired power project in Nigeria
- \$10m equivalent partial guarantee to enable an Indian Infrastructure Finance institution to access the 10 year rupee bond market
- \$35m equivalent 9 year partial guarantee for a new cement plant in Assam, India
- \$16m equivalent partial guarantee for a broadband backbone service in Niger

Sample Transactions

Potential transactions

- \$40m 15 year guarantee for a \$200m toll road in Kenya
- \$340m steel plant in Orissa, India
- \$32m subordinated and mezzanine tranches for a \$105m securitisation of housing micro finance mortgage receivables in Central and Southern America
- \$40m subordinated loan in a \$250m 12 year mobile phone mast financing in India
- \$52m gtee facility out of a \$120m 15 year toll road financing in Nigeria
- \$35m partial gtee for second mobile phone operator in Palestine
- \$14m partial gtee for a new factory producing steel pipes for the water sector in Algeria

UN-HABITAT Slum Upgrading Facility

Presented by Ms. Ruth McLeod, Slum Upgrading Facility Pilot Team, Emerging Markets Group

The Slum Upgrading Facility of UN-HABITAT was established in 2004 to examine ways in which innovative finance mechanisms can help address the problem of urban slums. In 2006, the Pilot Project phase of Slum Upgrading Facility began, and it was in this phase that the concepts of “Finance Plus” and Local Finance Facilities began to take shape. Slum Upgrading Facility and the Local Finance Facilities build very much on the earlier experiences of others, such as Community-Led Infrastructure Finance Facility and Homeless International. Slum Upgrading Facility differs in that it brings key players together within the Local Finance Facilities, and that it has a strong partnership with local authorities as well as community members and private sector finance institutions.

Local Finance Facilities have been or are being established in Ghana, Indonesia and Sri Lanka and Tanzania. Local Finance Facilities bring key players together, catalyze the integration of commercial finance into slum upgrading and provide mechanisms to blend different forms of finance to maximize affordability. There are differences between the Local Finance Facilities. In Ghana, two city level Local Finance Facilities have been established, while in Sri Lanka, one national Local Finance Facilities was set up.

The Local Finance Facilities all need to be capitalized, and they will then offer guarantees for wholesale loans and project loans, technical assistance for project design and loan negotiations and grants for initiating projects – “Finance Plus”.

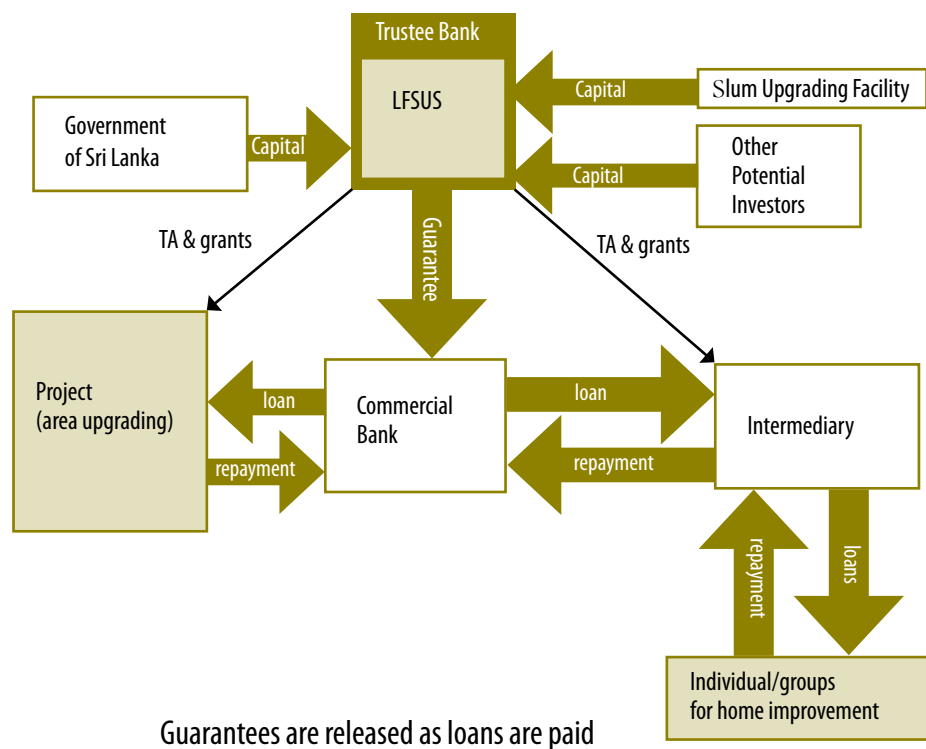
COUNTRY	Ghana		Sri Lanka	Indonesia	
CITY	Tema	SAEMA	National	Solo	Yogja
SERVICES TO BE OFFERED	✓	✓	✓	✓	✓
Guarantees for wholesale loans	✓	✓	✓	✓	✓
Guarantees for project loans	✓	✓	✓	✓	✓
Occasional bridge financing loans	✓	✓	✓	✓	✓
Technical assistance for project design	✓	✓	✓	✓	✓
Technical assistance for loan negotiations	✓	✓	✓	✓	✓
Grants for initiating projects	✓	✓	✓	✓	✓
SOURCE OF FUNDS					
Slum Upgrading Facility PMU	✓	✓	✓	✓	✓
Local Government	✓	✓		✓	✓
National Government			✓		
Other					
TYPES OF INITIATIVES					
Planned home improvement programme		✓	✓	✓	
Planned area improvement project	✓		✓		?

There will be criteria for providing credit enhancement to a project as follows:

- The project will enhance slum upgrading an/or settlement upgrading for low-income households.
- The project is designed to ensure affordability by low-income households.
- A detailed implementation and management plan has been developed for the project.
- A detailed financial plan has been developed for the project and incorporates a commercial borrowing component.
- A risk analysis for the project has been carried out and a risk mitigation and management strategy developed;
- The organisation responsible for implementing the project is well organised with proper procedures and systems in place;
- The agency taking out the loan for the project is properly registered and can demonstrate good financial planning and management capacity;
- The project is supported by the local authority and the community or communities involved, and;
- One or more banks have been identified as potential lenders to the project.

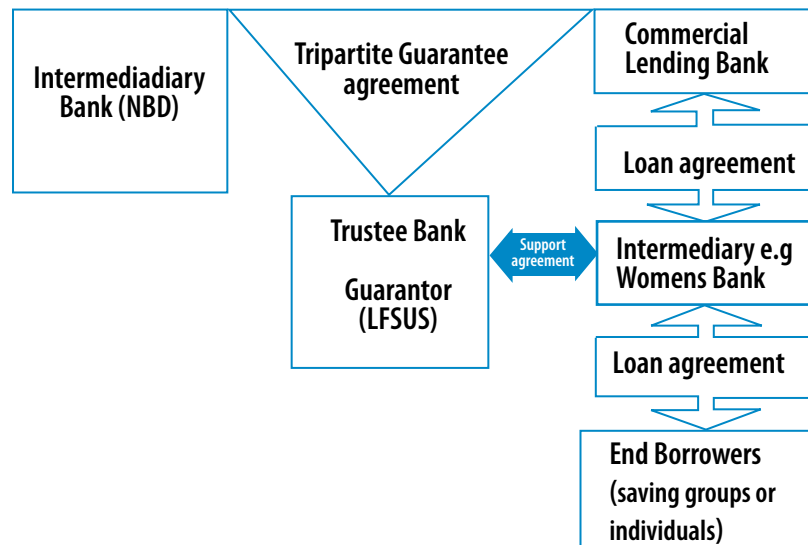
How will Local Finance Facilities work?

Figure 4 Financial flow



What are the guarantee arrangements?

Figure 5 Guarantee arrangement (Tripartite)



Slum Upgrading Facility and the Local Finance Facilities are working to manage the complexity - of savings and loan systems, land, infrastructure, housing design, commercial components and affordability. there is potential for many benefits - guarantee gearing, credit track record, land security, improved infrastructure, employment, skills and financial inclusion for the urban poor.

UN-HABITAT Experimental Reimbursable Seeding Operation (ERSO)

Presented by Christian Schlosser, UN-HABITAT

ERSO (Experimental Reimbursable Seeding Operations and other Innovative Financial Mechanisms) is designed to operationalize UN-HABITAT Governing Council Resolution 21/10 through the establishment of a trust fund within the United Nations Habitat and Human Settlements Foundation for a four-year experimental period from 2007 to 2011 to support the introduction of experimental reimbursable seeding operations as well as other innovative financial mechanisms.

ERSO will provide seed-capital to domestic financial institutions (Banks, Microfinance Institutions) in form of loans or credit enhancements in combination with/or technical assistance activities to catalyze investments in pro-poor housing, related infrastructure and upgrading in close partnerships with national and local governments and support by local intermediaries.

ERSO Approach and delivery model

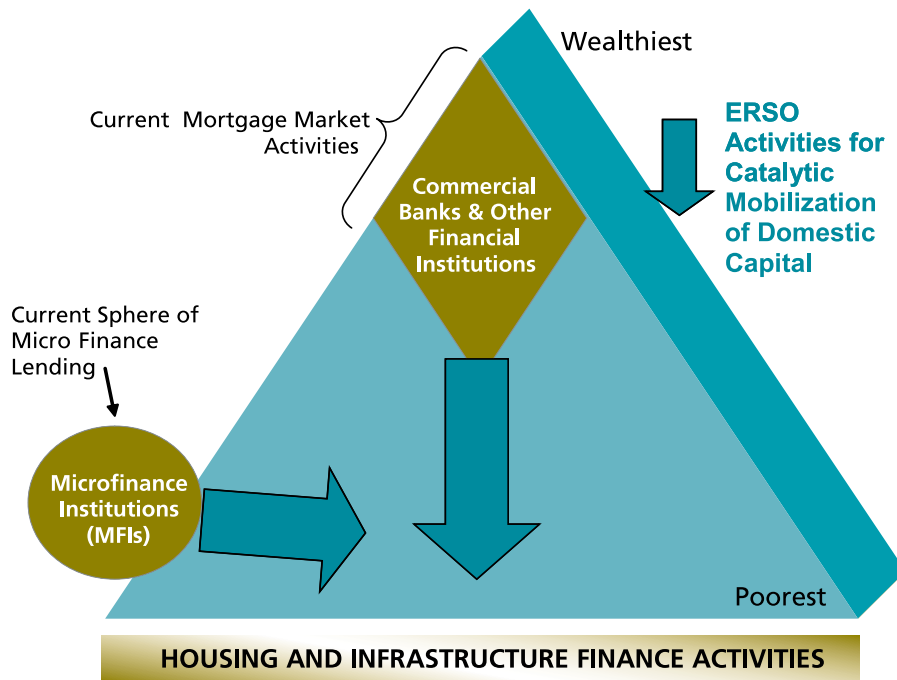
ERSO will apply a two-tier strategy comprising a “top-down” approach and a “bottom-out” approach. From the top down, ERSO seeks to encourage, induce and enable established domestic financial institutions that currently provide financing for upper and middle class housing to move “down market”. From the bottom out, ERSO will encourage, induce and enable Micro-finance institutions that currently provide financial services for the poor in other sectors than housing to both expand their services laterally as well as to develop new financial products that facilitate both the provision of and access to adequate shelter solutions.

ERSO Delivery model

ERSO Two-Tiers Approach for the Catalytic Mobilisation of Domestic Capital

Consequently, target groups of ERSO products are either low-income clients themselves or actors involved in the provision of lower income shelter.

ERSO seed capital in form of loans as credit enhancements as well as other innovative financial mechanisms will be provided to domestic financial institutions (Banks, Microfinance Institutions) to enable loans for low-income housing and infrastructure in combination with technical assistance to catalyze investments in pro-poor housing, related infrastructure and upgrading in close partnerships with national and local governments and support by local intermediaries.

Figure 6 ERSO Delivery Model

Targets

ERSO plans to test 8-12 operations in total with 2 to 3 in each of the 4 regions of Africa, Asia, Eastern Europe, Latin America/Caribbean. The target volume for each ERSO project is between US\$ 2 and 5 million. It is expected that the mobilization of domestic and international capital will serve an average of 500 households through a sustainable reimbursable financial model.

With an ERSO contribution to each operation of up to US\$ 1.5 Million and typically between 0.5 and 1 million, the target for the total volume of the ERSO Trust Fund is around US \$15 million. ERSO projects will comprise three elements: seed capital, credit enhancements and technical assistance in the form of grants, which will be used to mobilize domestic and international investment. In the short-term the target mobilization ratio is 1:1, while eventually a target of 1:4 will be the goal. Therefore, the aspiration is that each dollar of ERSO seed capital will leverage 4 dollars of domestic and international investment.

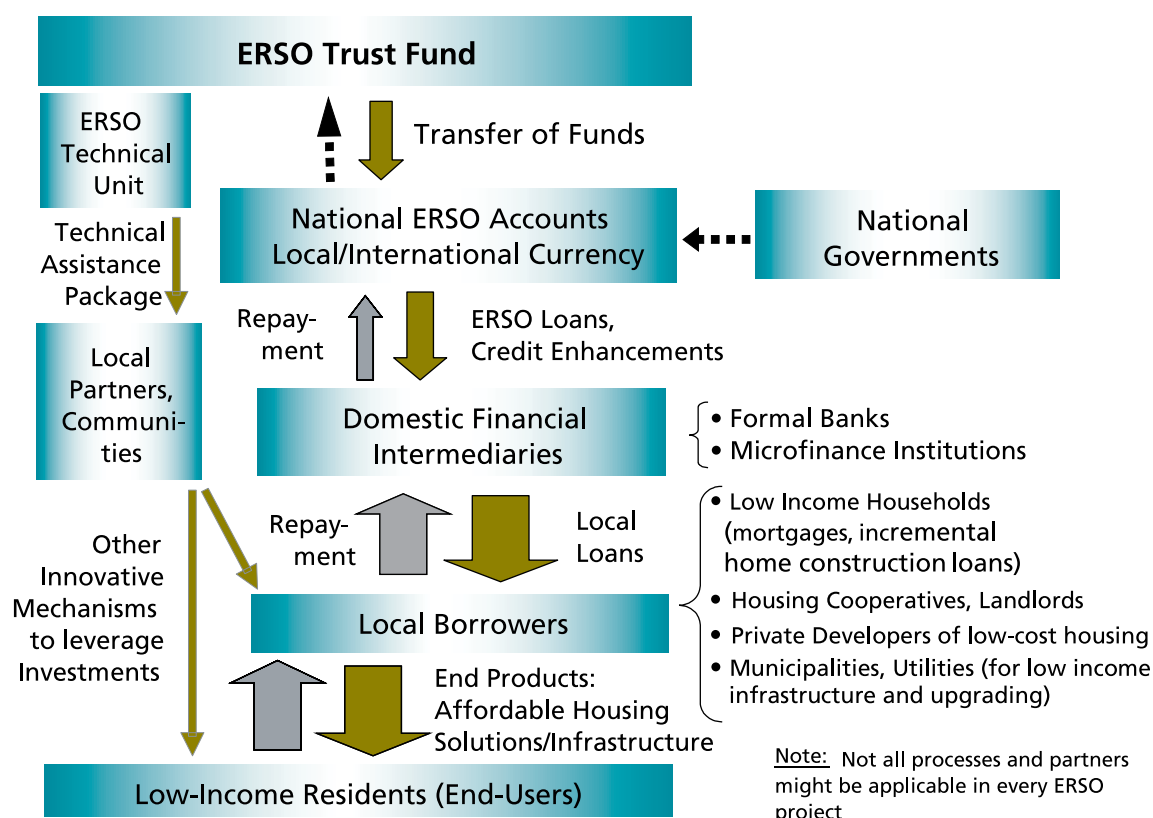
The ultimate goal of the experimental ERSO projects is to test methodologies that can be taken to scale. To this end, the projects will be designed and selected based especially on their demonstration value, their replicability and their potential for success. The projects will seek to employ innovative financial mechanisms to facilitate the access of low-income community groups and households to financing for

adequate shelter solutions, thereby increasing the effective demand for adequate low-income housing solutions. The projects will be demand driven and will be carefully selected in accordance with a set of macro-level and micro-level project selection criteria. In line with the mandate of UN-HABITAT and Resolution GC 21/10, ERSO projects and supported activities will target low-income households in developing countries.

ERSO Delivery model

Current Funding and Tasks for Implementation

Figure 7 ERSO Delivery Model



Currently, the ERSO Trust Fund is capitalized with US\$ 3.5 million with contributions from the Government of Spain and the Kingdom of Bahrain.

The tasks to be addressed in the next 6 months are:

- Establish the ERSO Technical Unit within UN-HABITAT;
- Identify potential ERSO Projects and develop Business Plans in cooperation with potential partners;
- Select projects and develop legal agreements with domestic implementation partners, and;
- Seek additional contributions to the ERSO Trust Fund.

List of participants at the guarantees workshop, 6 – 7 August 2008, Coventry, United Kingdom

Slum Upgrading Facility guarantees meeting participants

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7 Glossary

Asset: Anything owned by an individual or organisation having monetary value. This is a highly contentious and difficult concept as one of the main assets that the urban poor have is knowledge.

Asymmetric Information: Information that is known to some people but not to others. This definition will often be used to describe the different knowledge bases that banks and the urban poor and their support non-governmental organisations have.

Claw back period: the period that you cannot fully redeem your mortgage or payback your loan. Lenders typically offer discounts, subsidies and other perks, but they define a claw-back period during which you cannot redeem your loan without paying back the subsidies and perks.

Collateral: An asset that is pledged as security to ensure repayment of a loan. This can take many forms ranging from a house or land, through to household assets, such as jewellery, televisions or goats. The main requirement is that the security can be taken away if the loan is not repaid, and will have a value to the lender that will at least partly compensate for the loss they will experience in the case of non-repayment.

Credit enhancement: A method whereby a company attempts to improve its debt or credit worthiness. Credit enhancements take many different forms. They could be in the form of a financial guarantee, or in allocation of land or provision on infrastructure to a project.

Credit rating: A lender's assessment of a borrowers' credit worthiness. When the borrower is an individual, assessment is usually based on past history of borrowing and repayment, employment status and other information supplied by the borrower in an application. When the borrower is an organisation, assessment is usually based on key accounting information such as the balance sheet or the viability of the venture for which loan finance is being sought. Sometimes credit worthiness is assessed by a credit rating agency.

Due diligence: A term used for a number of concepts involving either the performance of an investigation of a business or person, or the performance of an act with a certain standard of care. It can be a legal obligation, but the term will more commonly apply to voluntary investigations.

Escrow: When someone else holds assets of yours until the term of the contract or agreement are fulfilled, your assets are said to be held in escrow. The assets could be money, securities, real estate or a deed.

First loss: Where the guarantor provides security for a certain percentage of the first loss. For example, on a 50% first loss guarantee, in the case of default, the first 50% of the loan that is not repaid is covered by the guarantee, while any losses beyond 50% are covered by the bank.

Guarantee: A legal agreement to provide security for a loan. If the loan is not repaid according to the terms and conditions agreed, the guarantor must give up the security that has been provided. Forms of security vary: collateral (see above) or cash deposits may be acceptable. Guarantees provide the lender with a level of security that makes lending easier, either because it reduces actual credit risk, or because it helps a financial institution to comply with central banking regulations that require such security as a means of making lending more secure.

Material alteration: Addition to or deletion of text from a legal instrument (contract, deed, will, etc.) that significantly changes its legal sense or effect, and may thus invalidate it.

Moral hazard: The prospect that a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk. Moral hazard arises because an individual or institution does not bear the full consequences of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to bear some responsibility for the consequences of those actions. In the context of guarantees, moral hazard may arise if for example banks do not make efforts to collect loan repayments, or borrowers do not make efforts to repay, because there is a guarantee in place that insulates them from risk.

Pari passu: A Latin phrase that literally means “with equal step”. In the context of guarantees, it means that the guarantor and the lending bank split the risk on a 50/50 basis of actual realized loss.

Refinancing: the practice of an existing debt being either extended or increased, or taken over by an alternative debt provider. For example, when the development costs of a project have been met, further arrangements may be negotiated so that units within the scheme can be paid for over a longer time period.

Realised loss: A loss recognized when assets are sold for a price lower than the original purchase price. In the context of guarantees, it is the amount of the loan that is not repaid.

Sensitivity testing: A technique to assess the effects of changes on a project. It involves changing the value of one or more selected variables and calculating the resulting change in the net project value and, in the case of slum upgrading, affordability and bankability. Sensitivity testing is useful for large projects, or for projects with considerable uncertainty. Recommendations and actions can then be taken to address some of the areas where variables have a large impact.

Standby letters of credit: A guarantee of payment issued by a bank on behalf of a client that is used as “payment of last resort” should the client fail to fulfil a contractual commitment with a third party. Standby letters of credit are created as a sign of good faith in business transactions, and are proof of a

buyer's credit quality and repayment abilities. The bank issuing the standby letter of credit will perform brief underwriting duties to ensure the credit quality of the party seeking the letter of credit, then send notification to the bank of the party requesting the letter of credit (typically a seller or creditor).

Step in rights: Step in rights are used when a project starts to fail. A step in right allows a party who has a financial or other interest in the success of a project (such as a bank or guaranteeing organisation, or the government) to bypass the original borrower and pay the contractor directly, to allow the project to continue.

Transfer of Development Rights (Transfer Development Rights): The Slum Rehabilitation Authority in Mumbai uses transferable development rights (Transfer Development Rights) as an incentive to encourage developers to construct free housing for the city's slum dwellers under its slum development policy. Developers earn Transfer Development Rights at various stages of completion of approved developments for slum dwellers. Landowners who have released land for the construction of slum rehabilitation projects can also earn Transfer Development Rights. The Transferable Development Rights are issued in the form of a certificate which can either then be sold to another person or legal entity or used by the developer to develop new or existing property elsewhere, within a given area and under specified conditions.

Top Slice: A term that means taking the highest level of risk. For example, if a loan is issued for \$100, a guarantor who provides a 20% guarantee on a top-slice basis will pay for the first \$20 of loss or default (the full guarantee could be called in for a default of only 20 % of the loan). This contrasts with a 20% guarantee which is not top-sliced (effectively a 1:5 guarantee), where the guarantor would only cover 20% of the first \$20 of loss or default (i.e. \$4) and then 20% of all subsequent loss or default. Only if the entire loan of \$100 is in default would a guarantor have to pay the full \$20 in a "1:5" arrangement.

Wholesale loan: A single loan that can then be on-lent as smaller loans to multiple groups or individuals.

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FINANCING SLUM UPGRADING

✓ DO

✗ DON'T

Ensure that financing for slum upgrading is recognised as a priority within national development planning and as a key investment element contributing to economic growth. This emphasis should be reflected in a slum upgrading budget line within national and local authority budgets.

Encourage local and international banks and micro finance institutions to become active participants in financing upgrading as part of their core business.

Ensure that guarantees are available to encourage banks to lend to slum upgrading projects.

Build investment in slum upgrading on a firm foundation of community based savings and loan systems and local authority commitments to provide in kind and monetary allocations on an annual basis.

Recognise that financing for slum upgrading requires a mix of short, medium and long-term loans, integrating finance for building, infrastructure and livelihoods.

Provide mechanisms to blend municipal finance, cross subsidies and beneficiary contributions to ensure financial viability of upgrading projects and home improvement programmes.

Develop a process for sharing risk analysis and planning for risk mitigation and management with all the key stakeholders.

Plan projects on a mixed-use basis with revenue generating elements such as saleable residential units and rentable commercial space in order to maximise financial viability.

Ensure that subsidies are effectively targeted so that the benefits reach those for whom they are intended and build on the basis of long term engagement.

Recognise that not everyone who lives in a slum is poor. Where an area upgrading strategy is to be implemented provision needs to be made for a range of income groups with steps taken to ensure that the poorest are not excluded.

Recognise that home ownership is not the solution to everyone's problems. Provision for the development of affordable rental property is an important component of financing slum upgrading.

Make the real cost of finance very clear so that people clearly understand the commitments they are making to loan repayment.

Where appropriate establish local upgrading finance facilities so that funding is locally available.

Explore options to use land allocation, readjustment and sharing methods to release finance for upgrading.

Don't rely on one off poverty-focused upgrading projects.

Don't rely solely on housing or government finance institutions.

Don't provide guarantees that support interventions based on political patronage.

Don't assume that community involvement is best restricted to cost recovery and loan repayment and that local government has no responsibility for planning investment in upgrading.

Don't assume that one financial product fits all.

Don't rely on government subsidies or on full cost recovery from slum dwellers.

Don't expect residents of slums to be the only risk takers in developing new approaches to upgrading.

Don't assume that lending for slum upgrading will necessarily be asset-based. Where banks do lend for this purpose lending is more than likely to be revenue based.

Don't assume that all the problems of a slum can be addressed quickly with the framework of a single project.

Don't insist that interventions should only benefit low-income families.

Don't restrict interventions to developments based on clear land title and private ownership of property.

Don't hide the real cost behind misleading promotional messages.

Don't assume that existing finance institutions will have the capacity to deliver the full range of financial services required.

Don't place unnecessary restrictions on land use.



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